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Appendix A

INTERNAL REVENUE CODE OF 1954
(26 U.S.C. (1964 Ed.)):

Sec. 355. Distribution of Stock and Securities of a Controlled Corporation.

(a) Effect on Distributees.—

(1) General rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1) (D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) CROSS REFERENCE.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one

controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

Appendix B

45 T. C. No. 5

TAX COURT OF THE UNITED STATES

Oscar E. Baan and Evelyn K. Baan, Petitioners, *v.* Commissioner of Internal Revenue, Respondent.

Irving Gordon and Margaret Gordon, Petitioners, *v.* Commissioner of Internal Revenue, Respondent.

Docket Nos. 949-63, 3949-63. Filed October 19, 1965.

Pacific corporation was engaged in the telephone business in California and other western states. It transferred to Northwest, a newly created subsidiary, the assets used in the telephone business conducted in Oregon, Washington and Idaho. It thus became the owner of all of the Northwest stock which it subsequently distributed through the medium of short-term rights issued to its stockholders. *Held,* the transaction was a tax-free spin-off under Section 355, I.R.C. 1954, and petitioner-stockholders who obtained Northwest stock by exercising their rights did not thereby realize taxable income at that time. *Held further,* amounts realized by a shareholder of Pacific upon a sale of his rights to purchase Northwest stock are taxable as dividend income.

Harry R. Horrow and *Stephen J. Martin,* for the petitioners.

John W. Holt, for the respondent.

The Commissioner determined deficiencies against petitioners in Federal income taxes for 1961 in the following amounts:

Oscar E. and Evelyn K. Baan	$284.44
Irving and Margaret Gordon	895.10[1]

The principal question presented in these cases is whether petitioners received taxable dividends upon the exercise of rights issued to them by the Pacific Telephone and Telegraph Company enabling petitioners to purchase shares of its wholly-owned subsidiary, Pacific Northwest Bell Telephone Company. Also at issue is the tax treatment to be given to the amounts realized by petitioners in Docket No. 3949-63 upon the sale of four of the rights received by them.

FINDINGS OF FACT

The stipulation of facts filed by the parties together with the exhibits attached thereto is incorporated herein by this reference.

Petitioners Oscar E. Baan and Evelyn K. Baan, husband and wife, were residents of Sausalito, California, during 1961; they filed their joint Federal income tax return for the calendar year 1961 on the cash basis with the district director of internal revenue in San Francisco, California.

Petitioners Irving Gordon and Margaret Gordon, husband and wife, were residents of New York City during 1961; they filed their joint Federal income tax return for the calendar year 1961 on the cash basis with the district director of internal revenue in New York City.

At all times during 1961, the Baans owned 600, and the Gordons owned 1,540, shares of common stock of

[1]Petitioners Gordon paid this amount subsequent to the filing of the petition in this case.

Pacific Telephone and Telegraph Company, which had been purchased by them at various times prior to 1961.

The Pacific Telephone and Telegraph Company (hereinafter referred to as "Pacific") is a California corporation which furnishes communications services, mainly local and long-distance (toll) telephone services, in the State of California. Prior to July 1, 1961, it furnished such services also in the States of Oregon, Washington and a northern portion of Idaho.

Pacific Northwest Bell Telephone Company (hereinafter referred to as "Northwest"), a Washington corporation, has commencing on July 1, 1961, furnished such services in the territory previously served by Pacific in Oregon, Washington and Idaho. Bell Telephone Company of Nevada (hereinafter referred to as "Nevada"), a wholly owned subsidiary of Pacific, furnishes such services in Nevada.

Revenues from telephone services constitute approximately 90 percent of the total operating revenues of the three corporations. Other communications services furnished include teletypewriter services, and services and facilities for private-line teletypewriter use, for the transmission of radio and television programs and for other purposes. Revenues are also received from the sale of advertising space in telephone directories.

In each state in which it operates, each of the three corporations is subject to regulation by a state public utility regulatory authority which has power within its jurisdiction to regulate intrastate rates, services and other matters, including but not limited to some or all

of the following: facilities, security issues, valuations, purchases and sales of property, budgets, the assessment of fees for the expenses of such authorities, and contracts and other relations with affiliated corporations. All three corporations are likewise subject to regulation by the Federal Communications Commission with respect to their method of accounting and to interstate rates, lines and services, valuations and other matters. The Federal Communications Commission prescribes a Uniform System of Accounts which it requires telephone companies to use in keeping their books.

American Telephone and Telegraph Company (hereinafter referred to as "American"), a New York corporation, has owned more than 80 percent of the voting stock of Pacific at all times since 1907. Including Pacific, Northwest and Nevada, there were 21 operating telephone company subsidiaries of American in 1961. Of these operating subsidiaries American owns substantially 100 percent of 15 of them.[2] American owns the following percentages of the outstanding stock of its remaining subsidiaries:

Company	Percent Owned
Illinois Bell Telephone Co.	99.32
Pacific*	89.62
Northwest	89.13
The Mountain States Telephone and Telegraph Co.	86.75
New England Telephone and Telegraph Co.	69.33

*Pacific owns 100 percent of Nevada.

[2] In two of these companies a small number of directors' qualifying shares are privately held. [The official report (45 T.C. 71) numbered this as footnote 1, and numbered all subsequent footnotes one number lower.]

American operates a network of cable, wire and radio circuits and related equipment for intercommunication between and through the territories of its telephone subsidiaries and of other telephone companies and for interconnection (including interconnection by underseas cables and by radio circuits) between telephone systems in the United States and those in many other countries or territories throughout the world.

American's telephone subsidiaries, including Pacific and Northwest, furnish local and toll service in the territories in which they operate and toll service between points within and points outside of such territories, toll service being furnished partly in conjunction with American and other telephone companies. American's subsidiaries operate in the District of Columbia and in every state except Alaska and Hawaii. American estimates that over 90 percent of the toll messages originating in the United States are routed in whole or in part over its lines or those of its subsidiaries.

During all of the year 1961 the capital stock of Pacific consisted of the following:

(a) 820,000 shares of 6 percent cumulative preferred stock authorized with a par value of $100 per share, entitled to 7 votes per share held, of which stock all 820,000 shares were issued and outstanding, with an aggregate par value of $82,000,000; and

(b) 105,000,000 shares of common stock authorized with a par value of $14-2/7 per share, entitled to one vote per share held, of which stock 104,756,943 shares were issued and outstanding, with an aggregate par value of $1,496,527,844.

As of December 31, 1960, Pacific had unappropriated earned surplus in the amount of $192,053,880.76. As of December 31, 1961, Pacific had $178,935,190.15 of unappropriated earned surplus and a capital surplus of $101,326,128.38. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its stockholders, to cover the dollar amounts which the Commissioner contends were received by the petitioners in these cases and by the other shareholders of Pacific in 1961 with respect to the distribution of Northwest stock. At all times during 1961, Pacific's long-term funded debt was $902,000,000.

Pacific has from time to time carried out its temporary financing by means of advances from American. These loans are evidenced by demand notes due one day after date of issuance, which bear interest at 4-½ percent per annum. Normally, Pacific discharges such advances through the use of the proceeds from its issuance and sale of its common stock and long-term debentures. The year end balance of such advances on Pacific's books and records, in millions of dollars, for the years 1956 through 1963 were as follows:

Year	Year End Balance
1956	$ 56
1957	82
1958	11
1959	161
1960	134
1961*	-0-
1962	140
1963	49

*As of June 30, 1961 advances outstanding amounted to $233,000,000.

American at all times during 1961 owned 90.25 percent of the outstanding common stock and 78.17 percent of the outstanding preferred stock of Pacific, representing in the aggregate 89.62 percent of the total voting power of Pacific.

The minority common and preferred shares of Pacific are publicly held. At the time of Pacific's annual shareholders' meeting in 1961 it had over 38,000 shareholders. For several years prior to 1961, during all of 1961, and at all times since 1961 the common shares and preferred shares of Pacific have been listed for trading on the New York Stock Exchange and the Pacific Coast Stock Exchange.

Commencing with the year 1907, Pacific has employed the calendar year as its accounting year and has kept its books of account to the extent permitted by law on the basis of the accrual method of accounting. Commencing with the year 1914, Pacific has filed its Federal income tax returns on the basis of the calendar year and to the extent permitted by law on the basis of the accrual method of accounting. Since January 1, 1913, Pacific has maintained its accounts in accordance with the Uniform System of Accounts for telephone companies prescribed originally by the Interstate Commerce Commission and since July 1934 by the Federal Communications Commission. For the taxable years 1924 through 1931, Pacific filed, as the parent corporation, consolidated Federal income tax returns with its own subsidiaries. For the taxable years 1932 through 1953, Pacific filed separate corporate Federal income tax returns. For the taxable years 1954 through 1962, Pacific was included as an af-

filiated subsidiary in the consolidated Federal income tax return of American. Commencing with the taxable year 1961, this consolidated Federal income tax return, with American as the parent corporation, included and was filed in behalf of Northwest as well as the other affiliated corporations. In none of the consolidated Federal income tax returns of American and its affiliates for the taxable years 1954 through 1962 did the members of the affiliated group elect, as permitted under Section 1.1502-31(b)(1) of the Income Tax Regulations, to take into account in the computation of consolidated taxable income the gains and losses reflected in certain intercompany transactions.

The parties have stipulated that "for more than five years prior to June 30, 1961, the operations of Pacific in the States of Oregon, Washington and a northern portion of Idaho, constituted one or more telephone communications businesses operated by Pacific which were separable from the telephone communications business operated by Pacific in the State of California". At all times after June 30, 1961, Pacific has continued in the operation of the telephone communications business in California, and Northwest has engaged in the operation of that business in Oregon, Washington and part of Idaho.

Between the end of World War II and January 1, 1961, there was a substantial increase in the demand for telephone service in the area served by Pacific. The number of telephones increased almost threefold from 2,700,000 to about 8,000,000. The investment in telephone plant (without deducting the depreciation reserve) increased more than fivefold from $662,000,000 to $3,402,000,000; and annual operating revenues increased more than four-

fold from $243,000,000 to $1,120,000,000. The operations of Pacific in the single State of California in 1960, in terms of plant investment and operating revenues, exceeded those of the entire company in California, Oregon, Washington and Idaho in 1957, and the operations of Pacific in Oregon, Washington and Idaho in 1960 almost equalled those for the entire company at the end of World War II. Growth in all the Pacific Coast states was continuing in 1961 at a rapid pace. Recent studies had predicted the population of California would increase from about 16,100,000 at the end of 1960 to more than 20,000,000 in 1970. Large population increases were also expected in the other states in which Pacific did business.

In terms of total capital, Pacific at the end of 1960 was the largest subsidiary corporation in the Bell System and the eighth largest non-financial company in the nation. On the same basis Northwest, as of July 1, 1961, was larger than eight and smaller than twelve of the other Bell System subsidiaries. It was the largest public service company in the Pacific Northwest area.

John O. Einerman, formerly an officer of American, has been vice president and comptroller of Pacific since March, 1958. Shortly after he joined Pacific Einerman was asked by the president of the company to undertake studies looking toward the division of Pacific into two or three separate companies. The basic problem which brought forth the need for such studies was understood by Einerman to be the tremendous growth of the telephone system on the Pacific Coast and the fact that the territory covered by Pacific encompassed about one-seventh of the continental United States. He worked with

a small group of people within the company and the company's lawyers considering various plans which were developed within this group. That group analyzed the financial impact of the various procedures that they considered. Einerman concluded that the studies showed that it would be extremely desirable from an operating point of view to divide Pacific into two separate corporations. As a result of the studies Pacific was divided into two separate divisions in 1960 and was then divided into two separate corporations in 1961.

In a meeting on January 27, 1961, the board of directors of Pacific resolved to submit to the shareholders of Pacific a plan entitled "Plan For Reorganization of The Pacific Telephone and Telegraph Company" (hereinafter referred to as the "Plan") for consideration at the annual meeting of the shareholders on March 24, 1961. At the request of the chairman, Einerman addressed Pacific's board of directors and explained the need for and purposes of the Plan, prior to the vote on the pertinent resolutions.

The reasons given for dividing the operations of Pacific were the size of the area served by the company (about one-seventh of the area of the mainland states); the rapid growth of the population of the area since World War II with increases in the number of telephones, and the amount of plant investment and operating revenues; and the expected continued growth of the population of the area with a continuing increase in the amount of telephone service required.

The advantages of having a separate division which had been set up in 1960 to run the operations of Pacific in

Oregon, Washington and Idaho were considered by management to be as follows:

1. Top authority closer to communities served.
2. Better recognition of service needs of each community.
3. More flexibility in dealing with customers.
4. Closer relations with employees.
5. Better understanding by public and authorities.
6. More efficient operations.

In addition, the following advantages were expected to be gained by the establishment of the Northwest Division as a separate corporation:

1. Financing problems, as well as operating problems, would be assumed by Pacific-Northwest management.

2. A board of directors with final authority, drawn from the territory served, would replace the then-existing advisory boards.

3. The Pacific Company management would be able to concentrate full attention to the needs of California and Nevada.

Under the terms of the Plan, the board of directors of Pacific was to cause a "New Company" to be incorporated under the laws of the State of Washington. The Plan further provided that:

> 3. The Pacific Company shall transfer to the New Company all of the business and properties of the Pacific Company located in the States of Oregon, Washington and Idaho, including all property, whether real or personal, tangible or intangible, fran-

chises, easements, rights-of-way, licenses, leases and all rights of any nature, whether existing or contingent at the time of transfer, arising out of or in connection with its business in the States of Oregon, Washington and Idaho, all of the foregoing being transferred in consideration for (i) the assumption by the New Company of all liabilities, whether existing or contingent at the time of transfer, of the Pacific Company relating to the business of the Pacific Company in such states, except liabilities with respect to any dividends declared on stock, income taxes for which liability reserves have been established and principal of and interest on the debentures and short term debt of the Pacific Company, and (ii) capital stock and debt obligations of the New Company in a total amount which will bear substantially the same relationship to the net book cost of the assets transferred and liabilities assumed as the total of the par value of the stock (common and preferred) and the aggregate principal amount of the debt obligations of the Pacific Company bears to the net book cost of all its assets less liabilities prior to said transfer, the par value of capital stock, debt obligations and surplus of the New Company to be in substantially the same proportions as the par value of stock (common and preferred), debt obligations and surplus of the Pacific Company prior to said transfer.

4. The Pacific Company shall offer to its shareholders as set forth below the right to purchase all of the shares of capital stock of the New Company acquired pursuant to this Plan. The number of shares to be offered to the shareholders of the Pacific Company in any one offering, the number of offerings to be made, and the price at which said shares shall be offered to the shareholders of the Pacific Company

shall be determined by the Board of Directors of the Pacific Company in its sole discretion, provided, however, that each offering shall be made to the shareholders of the Pacific Company on the following basis:

a. The holders of record, on such date as may be specified by the Board of Directors of the Pacific Company, of the common shares of the Pacific Company will receive rights to purchase stock of the New Company on the basis of a prorate offering entirely to such holders, subject to the following provisions. The holders of record, on such date, of the preferred shares of the Pacific Company other than American Telephone and Telegraph Company will receive rights to purchase such stock on the basis that each such holder of preferred shares, for each preferred share held, will receive seven times the number of rights to purchase stock of the New Company that holders of common shares will receive for each common share held. The rights to participate received by such holders of preferred shares will come from rights which American Telephone and Telegraph Company would otherwise receive with respect to its common shares.

b. In connection with the final offering of the shares of stock of the New Company, shares not sold upon the exercise of rights may be sold by the Pacific Company to American Telephone and Telegraph Company.

The sale of the Northwest stock through the issuance of rights to the shareholders of Pacific pursuant to the Plan was intended to serve the purpose of providing Pacific with additional capital funds required by Pacific for future operations in California. In each of the seven 12-month periods ended June 30, 1960, Pacific issued ad-

ditional common stock and/or long-term debentures. The proceeds from the sale of those securities, net of expenses and premiums, were $1,313,750,000, or an average for each of the seven years 1954-1960 of $187,678,600. In the 36-month period from July 1, 1960, through June 30, 1963, Pacific did not issue any additional common stock or debentures.

Before adopting the Plan, the management of Pacific considered various alternative proposals concerning the distribution of the Northwest shares. One such proposal was the distribution of the Northwest shares to the shareholders of Pacific without the payment by them of any consideration. This was dropped because Pacific's management was advised by its attorneys that it would be required to charge such a distribution to earned surplus, and it had insufficient surplus for this purpose. Pacific's management was advised that it could create a reduction surplus out of capital against which a distribution of the shares of Northwest could be charged, but such a reduction surplus would be required under California law to be used first to redeem all of the preferred shares of Pacific. Pacific's management was advised and believed, although possibly erroneously, that under California law Pacific's preferred shares were not subject to redemption. In addition, the desire of Pacific to raise new capital from the distribution of the Northwest shares would not have been fulfilled by such a method.

On March 24, 1961, a meeting of the shareholders of Pacific was held at which the Plan was approved and adopted, subject to consent and approval by the Federal Communications Commission and the public utility regu-

latory authorities in each of the States of Oregon, Washington and Idaho. At that meeting, Einerman addressed the shareholders regarding the Plan, setting forth substantially the same material that he had presented at the directors' meeting.

Pursuant to the Plan, Northwest was organized under the laws of the State of Washington on March 27, 1961, with an authorized capital stock consisting of 50,000,000 shares of one class common stock with a par value per share of $11. On March 28, 1961, 10,000 shares of such stock were issued by Northwest to Pacific upon the payment by Pacific of $110,000 in cash.

On March 31, 1961, Pacific and Northwest submitted to the Public Utilities Commissioner of Oregon a joint application for an order authorizing Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Oregon and for certain related orders. On the same date, Pacific and Northwest submitted to the Washington Public Service Commission a joint application for an order authorizing Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Washington and authorizing the issuance of common stock and debt obligations of Northwest and the acquisition thereof by Pacific. On the same date, Pacific and Northwest submitted to the Idaho Public Utilities Commission a joint application of Pacific to withdraw its tariffs from Idaho and of Northwest to file tariffs with the Commission for Idaho. On April 3, 1961, Pacific and Northwest filed with the Federal Communications Commission a joint application for a certificate to the effect that the present and future public convenience and neces-

sity required the acquisition and operation by Northwest of the interstate toll lines of Pacific located in the States of Oregon, Washington and Idaho, and for a certificate to the effect that neither the present nor future public convenience and necessity would be adversely affected by the discontinuance of interstate telephone and telegraph services by Pacific over the lines to be acquired by Northwest.

On May 15, 1961, the Idaho Public Utilities Commission issued its approval order; on June 5, 1961, the Washington Public Service Commission issued its order granting its approval; on June 12, 1961, the Public Utilities Commissioner of Oregon issued his order granting his approval; and, on June 15, 1961, the Federal Communications Commission issued its approval order and certificate.

At a meeting of the board of directors of Pacific on June 30, 1961, the transfer of assets from Pacific to Northwest as contemplated by the Plan was approved. As of 11:59 p.m. on June 30, 1961, all of the business and properties of Pacific in the States of Oregon, Washington and Idaho were transferred to Northwest in consideration for:

(a) the assumption by Northwest of outstanding liabilities relating to the operations of Pacific in such states, with the exception of liabilities with respect to dividends declared on stock, income taxes for which liability reserves had been established and principal of and interest on debentures and short-term debt of Pacific;

(b) the issuance to Pacific by Northwest of a promissory note payable on demand in the principal

amount of $200,000,000 bearing interest at the rate of 4½ per cent per annum; and

(c) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its $11 par value common stock, having an aggregate par value of $334,950,000.

As contemplated by the Plan, as of the close of business on June 30, 1961, Pacific ceased operation of the business in the States of Oregon, Washington and Idaho, and as of July 1, 1961, Northwest commenced operation of the business received from Pacific in the States of Oregon, Washington and Idaho.

The par value of stock, aggregate debt (including advances from American evidenced by promissory notes due one day after issue), surplus per books and net book cost of assets less liabilities (a) of Pacific immediately prior to the above-mentioned transfer and (b) of Northwest as of commencement of business on July 1, 1961, were as follows:

	(a) Pacific		(b) Northwest	
	Amount	**Percent**	**Amount**	**Percent**
Stock	$1,578,527,844	54.0	$335,060,000	58.0
Debt:				
Funded	902,000,000			
Advances from American	233,000,000			
Demand note			200,000,000	
Total debt		38.9		34.7
Surplus	207,043,321*	7.1	41,986,477**	7.3
Total Capitalization***	$2,920,571,165	100.0	$577,046,477	100.0

*Before reduction by retroactive depreciation adjustment.
**Before reduction by retroactive depreciation adjustment and by capital stock expense.
***Equal to net book cost of assets less liabilities.

The total capitalization of Northwest was arranged in such a way as to maintain substantially the same ratios of stock, aggregate debt and surplus as those of Pacific as set forth above. The proximate aggregate par value of capital stock of Northwest to be outstanding having been thus determined, the $11 par value per common share and the approximate number of common shares of Northwest to be outstanding were determined by March 27, 1961, the date of incorporation of Northwest. The $11 par was selected, after review of the normal relationship between par value and market price of the common shares of Pacific's stock, with a view to a price range for the common shares of Northwest's stock which would be most attractive to investors. It was believed that the relationship between the price range at which the Northwest stock would be traded on the exchange and the book value of the Northwest stock would be approximately equal to the relationship between the price range at which the Pacific common stock would be traded and the book value of the Pacific common stock, such future price range of Pacific common stock being forecast in the light of the current prices of Pacific common stock.

On the 1961 consolidated income tax return filed by American and its subsidiaries the transfer of assets from Pacific to Northwest was treated as a transaction coming under Section 351. It was reported that Pacific received from Northwest 30,450,000 shares of Northwest common stock; no securities of Northwest; no money; and other property in the form of a $200,000,000 demand note of Northwest. Since both Pacific and Northwest were included in a consolidated return in the year of the transfer, no gain or loss was reported on the transaction.

From March 28, 1961, until September 29, 1961, Pacific was the sole shareholder of Northwest. Pursuant to the Plan, on September 29, 1961, Pacific issued to its shareholders rights, evidenced by assignable warrants, to purchase 17,459,490 shares of the common stock of Northwest, constituting approximately 57.3 percent of the total outstanding common shares of Northwest.

In conformance with the provisions of paragraph 4(a) of the Plan, each minority common shareholder of Pacific of record at the close of business on September 20, 1961, was issued one right for each common share of Pacific so held. The number of common shares of Pacific so held by minority shareholders was 10,214,804. At the close of business on September 20, 1961, American held 94,542,139 shares of common stock and 640,957 shares of preferred stock of Pacific. Under the Plan, 1,253,301 rights were received by the minority preferred shareholders of Pacific on the basis of seven rights for each preferred share of Pacific held by them. These 1,253,301 rights came from rights which American would otherwise have received with respect to its common shares of Pacific, on the basis of one right for each common share of Pacific which American held. Consequently, American received on September 29, 1961, 93,288,838 rights with respect to its 94,542,139 common shares of Pacific. American received no rights with respect to its preferred shares of Pacific.

Under the terms of the offering, six rights and the payment of $16 were required for the purchase of each share of common stock of Northwest. The rights were required to be exercised no later than October 20, 1961.

The common stock of Northwest was listed on the American Stock Exchange and on the Pacific Coast Stock Exchange, and trading with respect to the shares of such stock commenced on September 14, 1961, on a when-issued basis. The rights issued by Pacific on September 29, 1961, were admitted to trading on the American Stock Exchange and on the Pacific Coast Stock Exchange and trading with respect to said rights commenced on September 14, 1961, on a when-issued basis.

Petitioners Baan exercised all of the 600 rights issued to them which entitled them to acquire 100 shares of common stock of Northwest and paid to Pacific $1,600 in cash ($16 per share) on October 11, 1961. Petitioners Gordon exercised 1,536 of the 1,540 rights issued to them which entitled them to acquire 256 shares of common stock of Northwest and paid to Pacific $4,096 in cash ($16 per share) on October 5, 1961. On October 5, 1961, petitioners Gordon sold the four rights to purchase Northwest stock which they had received from Pacific but did not exercise. The net proceeds from the sale of the four rights were $6.36.

The fair market values on selected dates of Pacific common and preferred stocks, as shown by the average of the high and low quotations on the New York Stock Exchange (the principal market in which such stocks were traded), and Northwest common stock, and the rights issued by Pacific to purchase Northwest common stock as shown by the average of the high and low quotations on the American Stock Exchange (the principal market in which such stock and rights were traded) were as follows:

Date	Pacific Common	Pacific Preferred	Northwest Common	Rights
1961				
Jan. 27	35.1250	149.0625		
June 30	37.6875	155.0000		
Aug. 25	43.5000	169.0000		
Sept. 14	42.2500	164.9375	29.8125	2.234375
Sept. 29	38.6250	142.5000	26.8125	1.765625
Oct. 5	39.4375	146.0000	26.0000	1.65625
Oct. 20	38.0000	150.5000	27.8125	1.953125

As a result of the offering, the minority common and preferred shareholders of Pacific or their assignees acquired by exercising rights 1,897,891 shares of common stock of Northwest, and American (after purchasing two additional rights privately) on September 29, 1961, acquired all of the 15,548,140 shares of such stock for which it had received rights. The 17,446,031 shares of Northwest thus acquired by the shareholders of Pacific or their assignees by exercising rights had an aggregate fair market value of $468,852,920 at the various dates of exercise of the rights. Pacific received by reason of such acquisitions, cash in the amount of $279,136,496, of which amount $248,770,240 was received from American by its check dated September 29, 1961.

In the consolidated income tax return filed by American and its affiliated companies for 1961, gain was reported by Pacific on the sale of the 1,897,891 shares of Northwest common stock by Pacific to its minority common and preferred shareholders in the amount of $8,739,362.07. Since both American and Pacific were included in a consolidated return for 1961 no gain was reported on the sale of 15,548,140 shares of Northwest common stock by Pacific to American.

The offering price of $16 per share to Pacific shareholders of the portion of the common stock of Northwest offered to them in 1961 was determined by Pacific at a meeting of its board of directors on August 25, 1961. At such meeting Einerman, at the request of the President of Pacific, outlined to the board of directors the reasons therefor.

In addressing the board Einerman stated that there were two basic decisions to make in connection with the first offering of Northwest shares: (1) the price to be set for each share; and (2) if the price set was in excess of par value whether a change should be made in Pacific's dividend to compensate the shareholders for the additional capital invested in Pacific. He then discussed the time schedule that had been established for the offering, all of the dates of which fell in 1961. The necessary registration statement was to be filed with the Securities and Exchange Commission on August 25, its effective date was scheduled for September 13. When-issued trading in the Northwest stock and rights would commence on September 14, and the stock would go ex-rights on September 15. The appropriate stockholders of record of Pacific on September 20 would receive such rights which would be mailed to them in the form of stock warrants together with a prospectus on September 29. Such warrants would expire if not exercised by October 20.

Seven factors were presented for consideration in setting the offering price for the Northwest stock to be sold through rights in 1961. There were questions raised during this presentation with regard to these seven factors but none of the questions raised nor any of the discussion

that followed uncovered any additional factors over and above the seven, and equal importance was given to each. Those factors listed on a chart which was used to present them to the board as "factors to be considered" were as follows:

1. Tax status of rights to be issued.
2. Market value of shares to be sold.
3. Rights values received in the past.
4. Rights values at various offering prices.
5. Company's requirements for new capital.
6. Proceeds at various offering prices and shareholder's investment above par.
7. Taxes to be paid at various offering prices.

Some of these factors argued for a high offering price whereas the others tended to support a low offering price.

In behalf of Pacific's management Einerman recommended to the board, after giving appropriate weight to all seven factors, that the offering price for the Northwest shares to be sold through rights be set at $16 plus six rights. All of management's recommendations as made to the board by Einerman on August 25, 1961, were approved, and the rights were issued as set forth hereinbefore.

In order to insure the success of a distribution of stock through an issue of rights, the difference between the fair market value of the stock and the option price, referred to as the underpricing, must be sufficiently large in two respects. First, the underpricing in terms of dollar amount must be large enough to make it worthwhile for share-

holders to sell their rights if they do not choose to exercise them. Normally a cash value of $.20 for each right would be adequate. Secondly, the percentage of underpricing must be large enough to make the purchase of the stock a good investment, and insure that the rights will be exercised. Taking into account that the issuance of Northwest stock by Pacific was not underwritten, the maximum underpricing necessary to insure the success of the issue would have been 10 percent.

On April 22, 1963, pursuant to the Plan, Pacific's board of directors resolved to offer the remaining 13,013,969 shares of common stock of Northwest held by it to the shareholders of Pacific of record on June 4, 1963. On June 12, 1963, Pacific issued to its shareholders rights evidenced by assignable warrants to purchase all such shares at a price of $16 per share, exercisable at any time before the close of business on July 3, 1963. Rights were received by the minority common shareholders, minority preferred shareholders, and American, the common parent corporation of Pacific on the same basis as the 1961 offering of Northwest shares, except that American relinquished rights to purchase 8,829 shares of Northwest which it would otherwise have received under the Plan with respect to its common shares of Pacific, so that the minority common and minority preferred shareholders of Pacific could be offered shares of Northwest on a one-for-eight basis. The exercise of eight rights was required for the purchase of each share of Northwest.

As a result of the 1963 offering, the minority common and preferred shareholders of Pacific or their assignees acquired by exercise of their rights 1,416,552 shares of

Northwest, and American acquired the balance at $16 per share, including the 11,580,456 shares for which it had received rights which it exercised, and 16,961 shares also acquired by American, as provided in the Plan, constituting the shares offered to the minority common and preferred shareholders of Pacific for which shares the rights were allowed to lapse by such shareholders, or a total for American of 11,597,417 shares. In the two offerings, in 1961 and 1963, American thus acquired a total of 27,145,557 shares of Northwest, or about 89.1 percent of its single class of common stock.

The offering price of $16 per share to Pacific shareholders for the portion of the common stock of Northwest held by Pacific in 1963 and offered to the shareholders through rights in 1963 was determined by Pacific at a meeting of its board of directors on May 24, 1963. That determination was based upon the same factors which were presented to the board in regard to the setting of the offering price on the 1961 offering of Northwest stock by Pacific.

In response to requests by Pacific, the Commissioner issued a ruling letter on June 28, 1961 regarding the tax consequences of the planned division of Pacific and distribution of Northwest stock to the shareholders of Pacific through an issue of rights. In regard to the issuance of the rights and the distribution of the Northwest stock the Commissioner ruled as follows:

(6) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.

(7) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

(8) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.

(9) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

On November 15, 1962, the Commissioner issued another ruling letter to Pacific which reaffirmed the positions taken in the ruling of June 28, 1961, as set forth above.

OPINION

RAUM, *Judge:* American Telephone and Telegraph Company ("American"), a New York corporation, owned all of the stock or at least a controlling interest in the stock of some 21 corporations engaged in the business of furnishing telephone and other communications services within the United States. In the aggregate, American and its various subsidiaries comprise what is sometimes referred to as the Bell System. Its stock ownership in its west coast s bsidiary, Pacific Telephone and Telegraph Company ("Pacific"), represented some 89 percent of the latter's voting control. The minority shares in Pacific were publicly held by over 38,000 stockholders, including petitioners.

Pacific operated within the States of California, Oregon, Washington and a part of Idaho. Between the end of World War II and the beginning of 1961, Pacific's telephone business experienced enormous growth and was expected to continue to expand at a rapid rate. Due to this growth and the size of the area served by Pacific, many of its activities were controlled locally within the various states in which it operated. Eventually a separate division was set up to operate almost autonomously in the States of Oregon, Washington and Idaho. It was then concluded that it would be preferable to disassociate completely the activities of that division from the operations of Pacific in California by a transfer of the entire business conducted in the three northern states to a new corporation to be followed by a distribution to the shareholders of Pacific of the stock of the new corporation. To accomplish this objective Pacific Northwest Bell Tele-

phone Company ("Northwest") was organized as a Washington corporation on March 27, 1961, and as of July 1, 1961, Pacific transferred to it all of the assets pertaining to operations in the area to be served by the new corporation. In return for the assets received, Northwest assumed some of the liabilities to which such assets were subject, issued to Pacific a promissory note payable on demand in the principal amount of $200,000,000, and issued to Pacific 30,450,000 shares of its $11 par value common stock having an aggregate par value of $334,950,000.[3]

Since Pacific was then in need of additional capital to finance its own operations in California, the Plan to distribute the Northwest shares to Pacific's stockholders was devised in such manner that it would provide Pacific with such needed capital at the same time. This was accomplished by Pacific's issuing transferable short-term rights to its shareholders to buy the Northwest stock.[4] In order to receive a share of Northwest it was necessary to surrender six rights and to pay $16 in cash. Such Northwest stock was expected to have and did in fact have a fair market value substantially in excess of the $16 subscrip-

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[3]Pacific had previously purchased for $110,000 in cash 10,000 shares of Northwest common stock at par, which the Government agrees was an integral part of the later transfer.

[4]Pacific thus disposed of some 57.3 percent of its Northwest stock in 1961 and the remainder in 1963. There is no dispute between the parties that the two offerings were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 percent of the Northwest stock in a single transaction.

The amount of stock (57.3 percent) covered by the first offering was determined in such manner that direct control of the new corporation (over 50 percent stock ownership) would pass immediately from Pacific to American.

tion price. The petitioners in both cases before us exercised their rights thus obtaining shares of Northwest having a fair market value considerably greater than the cash paid therefor; also petitioners Gordon had four remaining rights which they sold for $6.36. Two principal problems are thus presented for solution: (1) Whether petitioners in both cases realized dividend income to the extent that the Northwest stock had a fair market value in excess of the subscription price; and (2) what is the proper tax treatment of the cash received by the Gordons upon the sale of their remaining rights?

1. *Exercise of rights.* There is no serious question that, apart from certain specific provisions of the 1954 Code, the exercise of rights by Pacific's stockholders in the circumstances of this case would result in their receiving taxable dividends equal to the excess of the value of the Northwest stock over the subscription price. So much is clear from such decisions as *Palmer v. Commissioner*, 302 U.S. 63, and *Choate v. Commissioner*, 129 F. 2d 684 (C.A. 2).[5] However, petitioners contend that there

[5]The *Palmer* case has generally been regarded as based upon the theory that there may be a taxable dividend where the optioned stock is worth more than the subscription price at the time of the offering, and since the Northwest stock had a value substantially in excess of the subscription price at the time of issuance of the rights, there is not present here the condition for nontaxability that existed in the *Palmer* case itself. The scope of *Palmer* was considered at length in *Choate*, and, since the value of the Northwest stock on the dates of exercise of the rights herein was not in excess of its value on the date of issuance of the rights the problem which proved so troublesome in *Choate* is not before us. The Commissioner has charged petitioners with having received dividends only to the extent that the Northwest stock had a value on the date of exercise of the rights in excess of the subscription price, and such excess in turn was less than the corresponding excess as of the time of the offering.

are provisions in the 1954 Code which preclude the treatment of the foregoing amounts as taxable dividends. They argue that the transaction was completely tax-free under Section 355, dealing with the distribution of stock and securities of a controlled corporation (so-called spin-off or divisive reorganization), or alternatively under Section 354, involving exchanges of stock and securities in certain reorganizations. As a further alternative, they take the position that if Sections 355 and 354 are inapplicable, then the distribution resulting from the receipt of Northwest stock by petitioners was a distribution in partial liquidation of Pacific under Section 346(b), resulting in the realization of capital gains as provided therein. Since we have reached the conclusion that Section 355 is applicable, we do not pass upon the alternative contentions.

Section 355 is captioned "DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION." Subject to various conditions and limitations spelled out therein,[6] it was intended to provide for nonrecognition of gain or loss in a so-called spin-off or divisive reorganization, whereby a corporation divests

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[6]SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.—

(1) General Rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits

itself of one of its business enterprises through the medium of distributing to its stockholders the stock of a subsidiary in which such business is being carried on at the time of distribution. See Sen. Rep. No. 1622, 83rd Cong., 2d Sess., pp. 266-268. It is undisputed that the telephone

of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * * * * *

(3) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole

and communications operations conducted in Oregon, Washington and Idaho constituted a separate business; and it is also undisputed that if Pacific had transferred that business to Northwest solely for stock of the latter

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or in part, shall not be treated as stock of such controlled corporation, but as other property.

* * * * * * *

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

(here Pacific received a $200,000,000 note in addition to stock), and if Pacific had then distributed the Northwest stock without consideration to its own stockholders (rather than through the medium of stock rights), the distribution would have qualified as a nonrecognizable spin-off. Such distribution would have been what petitioners properly characterize as a classic case of a tax-free divisive reorganization. And we hold that neither the use of stock rights nor the presence of the note requires a different result under Section 355.

Subject to the conditions spelled out in the four subparagraphs (A) through (D), Section 355(a)(1) provides in substance that where a corporation (the "distributing corporation") distributes to its shareholders stock of a corporation controlled by it no gain or loss shall be recognized by the distributees. Cf. *W. E. Gabriel Fabrication Co.,* 42 T.C. 545, 551. The principal controversy herein relates to subparagraphs (A) and (C). Subparagraph (B) is not involved at all since there is no contention that the transaction was used as a "device for the distribution of the earnings and profits" of either Pacific or Northwest. And subparagraph (D) is involved herein only in a manner closely related to subparagraph (A).

The conditions of subparagraph (A) appear in Section 355(a)(1) as follows:

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.—

(1) General Rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, * * *

* * * * * * * *

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

* * * * * * * *

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

As we understand the Government's position, it is that the conditions of (A) have not been satisfied since Pacific did not distribute the stock of Northwest but rather distributed rights to purchase the Northwest shares,[7] and that the stock of Northwest was in any event not distributed "with respect to its [Pacific's] stock". We think that these contentions are unsound.

The Government's position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve. This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states. Had it distributed the Northwest stock directly to its stockholders without

[7]It argues further at this point that such rights did not constitute "stock or securities" within Section 355 (a)(1)(A). In view of our conclusion that the shares of Northwest rather than the rights were the subject of the distribution within the meaning of (a)(1)(A) it becomes unnecessary to resolve the controversy as to whether the rights themselves would qualify as "stock or securities".

consideration there would clearly have been the type of divisive reorganization contemplated by the statute, at least as far as subparagraph (A) is concerned. And, in our view, the situation is not changed merely because that distribution was conditioned upon payment of $16 a share by the distributees. It was nonetheless a distribution of Northwest stock to these petitioners, stockholders in Pacific, made "with respect to" their ownership of stock in Pacific. If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock. The stock of Northwest was literally "distributed" to petitioners, albeit for a consideration, and we hold that the statute should not be construed so as to depart from such literal meaning, where to do so would frustrate the legislative purpose.

The Government's argument revolves largely around the notion that the rights to subscribe were the subject of the distribution rather than the Northwest stock itself, and that the stock was obtained only as a result of exercising those rights. However, *Palmer v. Commissioner*, 302 U.S. 63,[8] makes it clear that issuance of the rights,

[8]There is no merit to the Government's contention that *Palmer* is no longer good law in this respect. There is no indication in the 1954 Code that Congress intended to disapprove any part of that decision, and it has been applied by the courts in cases arising thereunder. See *William H. Bateman*, 40 T.C. 408. The employee stock option cases, *Commissioner v. LoBue*, 351 U.S. 243, and *Commissioner v. Smith*, 324 U.S. 177, relied on by the Commissioner as authority overruling *Palmer*, do not discuss this aspect of that case at all, but rather cite *Palmer* with approval in other respects.

even though they may be valuable, may not be considered as a distribution of corporate earnings and profits. If any income is to be charged to petitioners it must be regarded as stemming from the exercise of the rights, by obtaining the Northwest stock for a consideration less than its fair market value. But Section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, and we think it would be a distortion of Congressional purpose to impute an intention to impose the tax where the recipient was required in effect to contribute to the capital of the distributing corporation as a condition to receiving the distributed stock. We conclude that the transaction before us was within the terms of Section 355(a)(1)(A), and we next consider whether the conditions of (a)(1)(C) have been met.

Subparagraph (C) is not self-contained, but incorporates other provisions by reference; it spells out as one of the conditions for nonrecognition in Section 355(a)(1) that:

> (C) the requirements of subsection (b) (relating to active businesses) are satisfied

Thus, subparagraph (C) is really nothing more than the means whereby the provisions of subsection (b) are brought into play at this point.

Subsection (b) provides in part as follows:

(b) Requirements as to Active Business.—

> (1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation * * * is engaged immediately after the distribution in the active conduct of a trade or business, or

* * * * * * *

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) It is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in sub-paragraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

* * * * * * *

There is no dispute that Pacific and Northwest were each engaged in the active conduct of a trade or business within (b) (1) (A), or that the requirements of (b) (2) (A) and (b) (2) (B) have been met. However, the Government argues that there has been a failure in respect of Northwest to comply with (b) (2) (C), in that the transaction whereby Northwest acquired its business from Pacific was one "in which gain or loss was recognized in whole or in part." Petitioners vigorously deny that any gain or loss was recognized.

The purpose of these provisions was to prevent a tax-free distribution of a corporation's earnings and profits through the medium of a temporary purchase of a going business with liquid assets and then in effect distributing those assets to its stockholders. See Cohen, Silverman, Surrey, Tarleau and Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations,* 68 Harv. L. Rev. 393, 430. Plainly, no such circumstances were present here, since this case involves a bona fide separation of a business conducted for many years by Pacific. We turn then to the particular contentions urged by petitioners in support of their position that the gain on the transfer of assets by Pacific to Northwest was nonrecognizable. They rely upon two alternative grounds: (1) that as a result of the consolidated return filed in behalf of Pacific and the affiliated group, no gain or loss was in fact recognized; and (2) that in any event the transfer of the business by Pacific to Northwest was nonrecognizable under Section 351.[9]

It is in connection with this second ground that the matter of the $200,000,000 note becomes pertinent, since the Government contends that Pacific's transfer to Northwest was not "solely in exchange for stock or securities" of Northwest, in view of the note as part of the

[9]SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. * * *

consideration for the transfer. Petitioners, on the other hand, argue that the note is a security within the meaning of Section 351. We need not resolve this controversy, because, in our view, there was no recognizable gain or loss by reason of the consolidated return, and it therefore becomes unnecessary to consider the alternative ground.

As subsidiaries of American, Pacific and Northwest were included in the group of affiliated corporations for which a consolidated return was filed for 1961. Thus, the gain resulting from the transfer of assets from Pacific to Northwest which might otherwise have been subject to tax was eliminated in that consolidated return pursuant to regulations prescribed by the Commissioner under Section 1502. Those regulations provide as follows (Regulations 1.1502-31 (b) (1)):

> (b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:
>
> (1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:
>
> (i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

The Government does not dispute that the gain upon the transfer from Pacific to Northwest was properly relieved

of tax in the consolidated return. It argues, however, that the regulations provide for the *elimination* of gain or loss whereas Sections 355 (b) (2) (C) and 351 are phrased in terms of *nonrecognition* of gain or loss. It contends that the gain herein was "recognized" but "eliminated." We think that this distinction is spurious, and that the terms "elimination" and "nonrecognition" are intended to be synonymous in this context. Apart from the absence of any solid basis for the claimed distinction, a careful textual examination of the statute and regulations discloses that the word "eliminated" was used in the sense of "nonrecognition."

Under the regulations "unrealized profits and losses" arising out of intercompany transactions are to be "eliminated." Here, it is undisputed that the gain on the transfer from Pacific to Northwest was properly "eliminated," and therefore must have been an "unrealized" gain within the meaning of these provisions. Yet Section 1002 directs that, except as otherwise provided, the entire gain or loss on a sale or exchange of property determined under Section 1001 shall be "recognized." And Section 1001 (a) states that the gain on sale of property "shall be the excess of the amount realized therefrom over the adjusted basis***." Thus, if no gain were "realized" within the meaning of the regulations so as to justify "elimination," no such gain was "recognized."

This result is confirmed by examining the consequences that would follow in respect of the basis of the transferred property. Section 1051, dealing with the basis of property acquired in an intercompany transaction, provides as follows:

SEC. 1051. PROPERTY ACQUIRED DURING AFFILIATION

> In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Secretary or his delegate, without regard to intercompany transactions in respect of which gain or loss was not recognized.***

The basis of the property is thus to be determined "without regard to inter-company transactions in respect of which gain or loss was not recognized." However, if gain were "recognized" in such a transaction, the basis of the property in the hands of the transferee would be "increased in the amount of gain recognized to the transferor." Section 362.

Plainly, all of the foregoing provisions contemplate *nonrecognition* of gain or loss in intercompany transactions, with the result that the transferred property retains its basis in the hands of the transferee. If "elimination" meant something different from "nonrecognition," and if the Commissioner were correct here, then we would have the bizarre situation where the gain were "recognized" even though "eliminated" and the property transferred would acquire a stepped-up basis even though no tax were paid on the gain. We can hardly imagine the Commissioner accepting any such result without a struggle. The real difficulty is due to his unsound position here. We hold that the gain "eliminated" in the consolidated return was not "recognized," with the con-

sequence that the requirements of Section 355 (b) (2) (C) have been met, thus complying with the condition of Section 355 (a) (1) (C).

There remains finally for consideration whether the condition of Section 355 (a) (1) (D) has been met. As already noted subparagraph (D) is closely related to (A) as it is involved herein. It requires that—

> (D) as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), * * *

Certainly, Pacific disposed of every share of Northwest, retaining none whatever, thus satisfying the underlying objective of subparagraph (D).[10] The reasoning behind the Government's highly technical argument that Pacific did not "distribute" all the Northwest stock is basically the same as its position under (A), and rests on the notion that the issuance of the stock rights and the exercise thereof preclude a finding that Pacific had

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[10] That objective has been satisfied by Pacific's parting with every share of Northwest. However, if it be thought necessary that such distribution be made to the stockholders of Pacific, the fact that some shares were transferred to purchasers of rights rather than to the stockholders is immaterial here. For, not only did the ultimate transferees take through the stockholders, but in any event the record discloses that the stock rights sold represented only a small percentage of the rights issued, and at least more than 80 percent of the shares, constituting control under Section 368(c), were in fact distributed to shareholders of Pacific, thus satisfying either part (i) or (ii) of subparagraph (D).

"distributed" all of the Northwest stock. We reject that position here in accordance with the conclusion that we reached in respect of the argument relating to (A).

2. *Sale of rights.* The remaining issue concerns the taxation of the proceeds received by petitioners Gordon from the sale of four of the rights issued to them. This sale took place on October 5, 1961, and the Gordons received $6.36 for the four rights or $1.59 each. In *Gibson v. Commissioner,* 133 F. 2d 308 (C.A. 2), the court held that a sale of rights results in "ordinary income" at least "to the extent of the spread between the market value of the stock at the time of the issuance of the option and the option price for the stock" (p. 309).

The value of the rights herein on the issuance date, September 29, 1961, was greater than $1.59 per right so that there is not presented here any problem comparable to that considered in *Choate v. Commissioner,* 129 F. 2d 684 (C.A. 2), where the market value of the optioned stock increased after the rights were issued.

In *Gibson,* the court determined that the petitioner there received an option to obtain a distribution, and through a sale of her rights she anticipated that distribution. The amount realized in anticipation of the distribution was required to be treated in the same manner as the distribution itself. Cf. *Helvering v. Horst,* 311 U.S. 112.

Petitioners accept this reasoning, but contend that since under Section 355 the distribution of stock in the present case is nontaxable and no gain would be recognized until a sale of the stock, the amounts realized from a sale of the rights should be taxed in the same manner as gains

from sales of the stock, i.e., capital gains. This argument fails to take into account the nature of Section 355, which is a nonrecognition provision, and can be utilized only by those shareholders who come within its terms. Those shareholders who sold their rights did not come under Section 355 in respect of such rights,[11] and without Section 355 a distribution of the stock of another corporation would have resulted in the distribution of a dividend to the shareholders of the distributing corporation. The anticipation of such a distribution results in a realization of income which must similarly be treated as a dividend to which the dividends received credit applies. Cf. *Tobacco Products Export Corporation*, 21 T.C. 625.

Decision will be entered for the petitioners in Docket No. 949-63.

Decision will be entered under Rule 50 in Docket No. 3949-63.

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[11] The same would be true with respect to any other provisions, such as those in Section 354, upon which petitioners might rely as a ground for relieving them of the tax upon the exercise of the rights, even if we were to hold such provisions applicable in such circumstances, an issue that we found unnecessary to decide. See p. 35, *supra*.

Appendix C

United States Court of Appeals
For the Ninth Circuit

Commissioner of Internal Revenue, Petitioner, vs. Oscar E. Baan and Evelyn K. Baan, Respondents.	No. 20,863

[July 7, 1967]

On Petition for Review of the Decision of the Tax Court of the United States

Before: HAMLEY, MERRILL and ELY, Circuit Judges

HAMLEY, Circuit Judge:

The Commissioner of Internal Revenue (Commissioner) determined a deficiency in the 1961 income tax of Oscar E. and Evelyn K. Baan, in the amount of $284.44. Taxpayers petitioned the Tax Court for a redetermination of the Commissioner's finding. The Tax Court decided there was no deficiency, its opinion being reported at 45 T.C. 71. The Commissioner petitioned this court to review that decision.

During 1961, taxpayers owned six hundred shares of Pacific Telephone and Telegraph Company (Pacific) common stock. In that year they received six hundred stock rights, represented by transferable stock purchase war-

rants issued by Pacific, entitling them to purchase one share of Pacific Northwest Bell Telephone Company (Northwest) common stock for sixteen dollars and six stock rights.

On October 11, 1961, taxpayers exercised their stock rights and, in consideration for $1,600 ($16 per share) and the surrender of the six hundred stock rights, received one hundred shares of Northwest stock. The fair market value of Northwest common stock on October 11, 1961, was $26.94 per share.

In their joint federal income tax return for that year, taxpayers did not include as income any amount with respect to the issuance of the six hundred rights to purchase Northwest stock, or any amount with respect to the purchase by them of one hundred shares of Northwest stock upon the surrender of the six hundred rights and the payment of $1,600. The Commissioner determined that the difference between the fair market value of the Northwest stock received and the sixteen dollars per share paid constituted a taxable dividend.

In the redetermination proceedings the Tax Court rejected the Commissioner's contention. The issue has been renewed in this review proceeding. The essential facts are not in dispute and the following statement of those facts is taken, almost verbatim, from the Commissioner's opening brief.[1]

Prior to July 1, 1961, Pacific, a California corporation, furnished communication services in California, Oregon, Washington and part of Idaho. Beginning in 1960, the

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[1]A more complete statement is set out in the Tax Court's reported statement of facts and opinion, at 45 T.C. 71.

California and non-California businesses of Pacific were operated by separate divisions. For a number of business reasons, the management and shareholders of Pacific decided early in 1961 that the non-California business should be handled by a separate corporation. Accordingly, on March 27, 1961, Pacific caused the organization of Northwest, a Washington corporation. The following day ten thousand shares of Northwest common stock were issued to Pacific upon the payment by Pacific to Northwest of $110,000 in cash.

As of June 30, 1961, all of the business and properties of Pacific in Oregon, Washington and Idaho were transferred to Northwest in exchange for (1) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its common stock, (2) the issuance to Pacific by Northwest of an interest-bearing demand note in the amount of $200,000,000, and (3) assumption by Northwest of certain liabilities of Pacific in Oregon, Washington and Idaho. At the close of business on June 30, 1961, Pacific ceased all operations in Oregon, Washington and Idaho, and Northwest commenced operations in these states on the next day.

An integral part of the plan for dividing the businesses of Pacific was the sale of Northwest stock to Pacific shareholders or their assigns. Assignable stock rights were to be issued to Pacific shareholders which would enable them either to purchase Northwest stock upon surrender of the rights plus the payment of cash in an amount to be set by Pacific's board of directors, or to sell the rights to others who could so exercise them. The purpose of the plan to require a cash payment in addi-

tion to the surrender of the stock rights was to provide Pacific with funds for its future operations in California.

On August 25, 1961, Pacific's board of directors decided that the offering price of Northwest stock to Pacific shareholders, or to those who had purchased the stock rights from shareholders, should be sixteen dollars per share. Pacific shareholders were to receive one transferable stock purchase warrant for each share of Pacific held, with six rights plus the payment of sixteen dollars required to obtain one share of Northwest stock. Between the time of the issuance of the rights (September 20, 1961) and the deadline for their exercise (October 20, 1961), the fair market value of Northwest stock was no less than twenty-six dollars per share.

The Northwest stock disposed of by Pacific in the above-described 1961 offering amounted to approximately fifty-seven percent of the total number of Northwest shares held by Pacific.[2] It had been planned by Pacific

[2]American Telephone and Telegraph Company (American), owned approximately ninety percent of Pacific's common stock. The bulk of the total of 17,446,031 shares of Northwest sold by Pacific in 1961, namely 15,548,140 shares, was thus acquired by American. The minority shareholders of Pacific, or their assignees, acquired the remaining 1,897,891 shares of Northwest. For the Northwest stock it sold in 1961, Pacific received cash in the total amount of $279,136,496.

On the consolidated income tax return filed by American and its subsidiaries for the year 1961 (which return included Pacific) no gain or loss was reported on the transaction in which Pacific transferred its non-California assets to Northwest. Similarly, since it was not required to report gains or losses in certain inter-company transactions, no gain was reported on the 1961 consolidated return on the sale of 15,548,140 shares of Northwest common by Pacific to American. Gain was reported by Pacific, however, in the amount of $8,739,362.07, with respect to the 1,897,891 shares of Northwest sold by Pacific to its minority shareholders or their assignees in 1961.

from the outset that the remainder would be held for disposition at a later time to be determined by Pacific's board of directors. The remaining forty-three percent of Northwest stock held by Pacific was offered to Pacific's shareholders on June 12, 1963, at the same price of sixteen dollars per share, the principal difference being that eight stock rights, instead of six, were required.[3]

As of December 31, 1960, Pacific had unappropriated earned surplus in the amount of $192,053,880.76. As of December 31, 1961, Pacific had $178,935,190.15 of unappropriated earned surplus. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its shareholders to cover the dollar amounts which the Commissioner contended in this case were received by taxpayers and other shareholders as dividend income.[4]

On these facts, the Tax Court decided that the transaction whereby Pacific sold its non-California business to

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[3]As a result of the June 12, 1963 offering of the remainder of Northwest stock, American acquired an additional 11,597,417 shares of Northwest, and the minority shareholders of Pacific acquired the remaining 1,416,552 shares of Northwest.

[4]In response to requests by Pacific, the Commissioner issued a ruling letter on June 28, 1961, regarding the tax consequences of the planned division of Pacific and the distribution of Northwest stock through an issue of assignable rights and the payment of cash. Essentially, the Commissioner ruled that, in the case of Pacific's shareholders who sold their rights, the full amount realized would be ordinary income to them and that, in the case of individual Pacific shareholders who exercised their rights, the difference between the fair market value of Northwest stock (on the date the rights were exercised) and the sixteen dollars per share price paid would be taxed to such shareholders as dividend income. On November 15, 1962, the Commissioner issued another ruling letter to Pacific which reaffirmed the position taken in the ruling of June 28, 1961.

Northwest and then sold the Northwest stock to its own shareholders or their assignees, qualified as a tax-free spin-off within the terms and intendment of section 355 of the Internal Revenue Code of 1954, 26 U.S.C. § 355 (1964).[5] Consequently, the Tax Court ruled that the taxpayers were not taxable on the gain realized by them when they exercised their rights to acquire Northwest stock having a fair market value of $26.94 per share at a cost to them of sixteen dollars per share.

As the Tax Court stated in its opinion, there is no serious question that, apart from certain specific provisions of the 1954 Code, the exercise of rights by Pacific's stockholders in the circumstances of this case would result in classifying, as taxable dividends, the excess of the value of the Northwest stock over the subscription price. As indicated above, section 355 was primarily relied upon by taxpayers in seeking, and the Tax Court in granting, non-recognition of the gain realized by taxpayers as a result of their exercise of the rights in question.

The Commissioner argues, however, that four specific requirements of section 355 remain unsatisfied in this case and it was therefore error to grant, on the basis of that statutory provision, non-recognition to this otherwise taxable gain. Section 355 is quoted in the margin.[6]

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[5]Section references throughout this opinion will be to the Internal Revenue Code of 1954, unless otherwise expressly stated.

[6]Section 355 reads as follows:

"§355. *Distribution of stock and securities of a controlled corporation.*

"(a) *Effect on distributees.*

"(1) *General rule.*

"If—

"(A) a corporation (referred to in this section as the 'distributing corporation')—

Before discussing these asserted requirements of section 355, and the question of whether they were here satisfied,

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"(i) distributes to a shareholder, with respect to its stock, or

"(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

"(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

"(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

"(D) as part of the distribution, the distributing corporation distributes—

"(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

"(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporaion of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

"(2) *Non pro rata distributions, etc.*

"Paragraph (1) shall be applied without regard to the following:

"(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

"(B) whether or not the shareholder surrenders stock in the distributing corporation, and

"(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

it will be helpful to review briefly the legislative history of that section.

"(3) *Limitation.*

"Paragraph (1) shall not apply if—

"(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

"(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

"For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

"(4) *Cross reference.*

"For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

"(b) *Requirements as to active business.*

"(1) *In general.*

"Subsection (a) shall apply only if either—

"(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

"(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

"(2) *Definition.*

"For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

"(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

"(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of such distribution,

A spin-off occurs where a part of the assets of a corporation is transferred to a new corporation and the stock of the transferee is distributed to the shareholders of the transferor without the surrender by them of stock in the transferor. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.100, page 491. Congress apparently first permitted the tax-free treatment of spin-off transactions in section 203(c) of the Revenue Act of 1924, ch. 234, 43 Stat. 256 (1924). Because of the general terms of that and subsequent enactments,[7] Congress soon recognized that wide-spread tax avoidance might result.[8]

"(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

"(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

"(i) was not acquired directly or through one or more corporations) by another corporation within the period described in subparagraph (B), or,

"(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period."

[7]Other similar enactments followed the 1924 statute: Revenue Act of 1926, ch. 27, § 203(c), 44 Stat. 13 (1926); Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 818 (1928); Revenue Act of 1932, ch. 209, § 112(g), 47 Stat. 197 (1932).

[8]At least arguably, the 1924 statute would have permitted the transfer of liquid assets to a new corporation. The new corporation's shareholders would then be in a position to liquidate the new corporation and so receive the liquid assets as a liquidating distribution taxable at capital gains rates. Such a transaction was actually litigated in *Gregory v. Helvering*, 293 U.S. 465. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) §§ 20.55, 20.101, pages 193-203, 496-498.

Congress reacted to this possibility by eliminating the provision which characterized the spin-off as a non-taxable reorganization. See the Revenue Act of 1934, ch. 277, 48 Stat. 680, 704 (1934). From then until 1951, without regard to whether a particular transaction served a legitimate business need, the gain realized by a shareholder as a result of a spin-off was subject to tax as an ordinary dividend.

In 1951, Congress reconsidered its position, having come to the view that business reasons could exist which would justify allowing tax-free status to the division of a single corporation into two or more corporations each owned directly by the shareholders. Therefore, in that year, Congress reinstated non-recognition treatment to those spin-offs which met carefully specified conditions. In so doing Congress additionally provided that ordinary dividend treatment would still be accorded the transaction, even if it would otherwise qualify under the new spin-off provisions, if the transaction was principally used as a "device" for distributing earnings and profits to the shareholders of any corporation that was a party to the reorganization. See section 112(b)(11) of the Internal Revenue Code of 1939, added by section 317 of the Revenue Act of 1951, ch. 521, 65 Stat. 493 (1951).

In the Internal Revenue Code of 1954, Congress sought to create a single set of limitations that would govern all forms of transactions having the potential of either a bona fide business transaction or a tax avoidance scheme. Under the 1954 Code, which is applicable in this case, such transactions, including not only spin-offs, but also so-called split-offs and split-ups, are to be tested under

the provisions of section 355.[9] In addition to further circumscribing the basic prerequisite for non-recognition, section 355 also carried over the "device" restriction that was part of the 1951 legislation. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.101, pages 494-503.

The Commissioner argues that, in the four following respects, each of which is indispensable, the transaction here in question failed to satisfy essential requirements of section 355:

(1) Pacific did not "distribute" solely stock or securities to taxpayers "with respect to its stock," as assertedly required by section 355(a)(1)(A).

(2) Since Pacific did not distribute "control" of Northwest without consideration, it did not meet the asserted requirements of section 355(a)(1)(D).

(3) Pacific did not distribute control of Northwest in a single distribution, as assertedly required by section 355(a)(1)(D).

(4) Contrary to the requirement of section 355(b)(2)(C), Northwest acquired its telephone business from Pacific in a transaction in which gain was "recognized."

We will first consider, together, the first two of these contentions. Both of them are generally directed to the

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[9] A split-off involves the same kind of transaction as a spin-off except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary. In a split-up, the parent corporation transfers substantially all its assets to two or more corporations and then liquidates, its stockholders surrendering all their stock in the transferor and receiving the stock in the transferee corporations. See Note, *Tax Treatment of Corporate Divisions*, 52 COLUM. L. REV. 408, 409 (1952); Mintz, *Divisive Corporate Reorganizations: Split-Ups and Split-Offs*, 6 TAX L. REV., 365 (1951).

section 355(a)(1)(A) provision that non-recognition of gain will be granted only if the distributing corporation (Pacific) distributes to a shareholder (taxpayers), "with respect to its stock" (with respect to taxpayers' ownership of Pacific's stock), "solely stock or securities" of a controlled corporation (Northwest) which the distributing corporation controls immediately before the distribution.

Beyond question, Pacific distributed stock rights to taxpayers with respect to their ownership of Pacific stock. This is shown by the fact that taxpayers received one stock right for each share of Pacific which they owned, without being required to give any consideration to Pacific.

This is not the kind of distribution, however, which is exempted from taxation under section 355(a)(1)(A). That statutory provision relates "solely" to the distribution of "stock or securities" of the controlled corporation.[10] Further, in view of section 355(a)(1)(D)(ii), which incorporates the "control" definition of section 368(c), the "stock or securities" distributed must carry voting rights. Stock rights are not stocks or securities and, most assuredly, are not stocks or securities carrying voting rights. They are only options to purchase stock. See *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 200-201.

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[10]The following statement appears in section 1.355-1(a) of the Treasury Regulations on Income Tax (1954 Code): "For the purpose of section 355, stock rights or stock warrants are not included in the term 'stock or securities.'" For a detailed discussion of the term "stock or securities," see 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.67, pages 285-286. But see Note, 35 U.CINC.L.REV. 254, 256 (1966).

It follows that section 355 does not here afford a basis for non-recognition of gain or loss unless the manner in which Northwest stock, as distinguished from the voting rights, was transferred from Pacific to taxpayers, constituted a "distribution" to them with respect to their ownership of Pacific's stock, within the meaning of that section.

For present purposes we may assume that intercession of a stock rights scheme would not, standing alone, prevent a transfer of Northwest stock from Pacific to taxpayers from constituting a distribution with respect to taxpayers' ownership of Pacific's stock. But this stock rights scheme did not stand alone. In addition to surrendering six stock rights, taxpayers were also required to pay sixteen dollars for each share of Northwest stock acquired. The transaction then became a sale of corporate assets.

Although the Supreme Court said in *Palmer v. Commissioner*, 302 U.S. 63, 69, that a sale of corporate assets to stockholders is, in a literal sense, a "distribution" of its property, we do not believe that it is the kind of distribution contemplated by section 355. Instead of being simply a distribution with reference to taxpayers' ownership of Pacific's stock, it is a distribution with reference to that ownership *plus* the payment of sixteen dollars a share.

As the Commissioner correctly states in his argument to this court, whatever meaning may be attached to the word "distribute," standing by itself or in a different context, the phrase "distributes . . . with respect to . . . stock" is a term of art with a consistent meaning

throughout the Code. It is used only to refer to distributions without consideration, not to sales for a cash consideration.[11]

Contrary to taxpayers' contention, there is no contradiction between a view which interprets only distributions without consideration as being within the section 355 phrase, "distributes . . . with respect to . . . stock," and the Commissioner's determination that taxpayers received a distribution from Pacific which is taxable as a dividend under section 301 of the Code, 26 U.S.C. § 301 (1964). It is true that both sections refer to a distribution made by a corporation to a shareholder ". . . with respect to its stock. . . ." However, section 355 relates this provision to the distribution of "solely stock or securities of a corporation . . .," whereas section 301 relates this provision to the distribution of "property (as defined in section 317(a))."

Section 317(a), 26 U.S.C. § 317 (1964), makes it clear that "property" is not limited to stock or securities but may include "any other property." Thus Pacific's distribution of stock rights "with respect to its stock" logically constitutes the distribution of property within the meaning of section 301, but, for the reasons stated above, does not constitute the distribution of "stock or securities" within the meaning of section 355.[12]

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[11]See section 301 (distributions of property), section 305 (distributions of stock and stock rights), section 307 (basis of stock and stock rights acquired in distributions), section 311 (taxability of corporations on distributions), and section 312 (effect of a distribution on corporate earnings and profits).

[12]Taxpayers point to sections 1.301-1(j) and (k) of the Treasury Regulations on Income Tax (1954 Code) as contradicting the

The dividend ruling by the Commissioner was with respect to the distribution of assignable stock rights to Pacific shareholders. It is true, as the Supreme Court said in *Palmer v. Commissioner,* 302 U.S. 63, 71, that the mere issue of rights to subscribe and their receipt by shareholders is not a dividend. But where, as in our case, this is coupled with the fact that, at the time of the distribution of stock rights, there is a "spread" between the fair market value of the stock and the purchase price as called for by the stock rights, an intention to declare a dividend is indicated. The amount of the dividend, determinable at the time the shareholder of the distributing corporation exercises his stock rights, is the lower of the "spread" on the date of issue or the "spread" on the date of exercise. See *Choate v. Commissioner,* 2 Cir., 129

Commissioner's contention that, throughout the 1954 Code, the phrase "distribution . . . to a shareholder with respect to its stock" never means distribution for a *cash* consideration.

Income Tax Regulation 1.301-1(j) does not pertain to distributions to a shareholder "with respect to its stock," but to the "transfer" of property by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange. With respect to such transaction, this regulation provides that such shareholder shall be "treated" as having received a distribution to which section 301 applies. The plain meaning of this regulation is to bring within the provisions of section 301, certain transactions which are not strictly distributions of property by a corporation "with respect to its stock."

Income Tax Regulation 1.301-1(k) demonstrates how (j) is to be applied, by giving as an example, a purchase by a shareholder, from his corporation, for twenty dollars, property having a fair market value of one hundred dollars. The rule indicates that under these circumstances the amount of the distribution determined under section 301(b) is eighty dollars. This example demonstrates that Regulation 1.301-1(j) does not deal with distributions of corporate property "with respect to its stock," but to other kinds of corporate transfers to shareholders which will nevertheless be treated as if they were stock distributions.

F.2d 684, 687. *Cf. Commissioner v. LeBue,* 351 U.S. 243, 249.[13]

Taxpayers call attention to the fact that, in view of section 355(a)(2)(B), there may be a section 355(a)(1)(A)(i) distribution to a shareholder "with respect to its stock," even though the plan calls for the shareholder to surrender stock in the distributing corporation.[14] Likening such a surrender of stock by a shareholder to the payment of consideration for stock being distributed to a shareholder, taxpayers argue that a distribution of stock of a controlled corporation under a plan which calls for a cash payment by the distributing corporation's shareholders, is likewise a distribution "with respect to its stock."

If, as part of a plan to distribute to its shareholders the stock of a controlled corporation, the distributing corporation requires that recipient shareholders surrender stock in the *distributing* corporation, it is patently a distribution to the shareholder "with respect to its stock," just as much as if no surrender of such stock were required. No factor unassociated with the shareholder's ownership of the distributing corporation's stock has been introduced. But where the plan requires a cash payment by a recipient shareholder, a new element, unassociated

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[13]In our case, the value of the Northwest stock on the date of exercise of the rights by the taxpayers did not exceed the value of that stock on the date of issuance of the rights.

[14]The provision of section 355(a)(2)(B), to the effect that section 355(a)(1) shall be applied without regard to whether or not the shareholder surrenders stock in the distributing corporation, was designed to make section 355(a)(1) applicable to "split-offs" and "split-ups," as well as "spin-offs." MERTENS, LAW OF FEDERAL INCOME TAXATION, Code Commentary, § 355(a): 3, page 219.

with a shareholder's ownership of the distributing corporation's stock, has been interjected.

As we view it, the impact of the section 355(a)(2)(B) provision to which taxpayers call attention, as related to our problem, runs against, instead of in favor of, taxpayers' position. Congress made clear in this section that a surrender of stock in the distributing corporation would not defeat a section 355(a)(1) transaction, but it made no such exception in the case of plans calling for cash payments from recipient shareholders.[15]

Taxpayers argue that sections 354 and 356 of the Code, 26 U.S.C. §§ 354 and 356 (1964), support their view that section 355 does not preclude the payment of cash by a tax-free distributee. We do not agree. Neither section 354 nor section 356 pertains to a distribution by a corporation "with respect to its stock," which is an express limitation in a section 355(a)(1)(A)(i) transaction under which taxpayers have sought to proceed.

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[15]Taxpayers also direct our attention to the fact that the term "distributes" as used in (ii) of section 355(a)(1)(A) clearly refers to transfers by a corporation for a consideration, namely exchanges by a distributing corporation of stock or securities of the controlled corporation for its own "securities." Taxpayers argue that the surrender of "securities" under this provision is one form of consideration, thereby indicating that the term "distributes . . . with respect to . . . stock," as used in (i) of section 355(a)(1)(A) was intended to be used in its broadest sense, and could include distributions involving a payment of a cash consideration by recipient shareholders.

However, this argument lacks substance when it is noted that the words "with respect to its stock" do not apply to distributions to a "security holder," under section 355(a)(1)(A)(ii), but only to distributions to a "shareholder" under section 355(a)(1)(A)(i). It is subparagraph (i), and not (ii), which is applicable in this case, since taxpayers receive the stock rights as shareholders "with respect to its stock," and not as security holders "in exchange for its securities."

In rejecting the Commissioner's contention that the requirement that sixteen dollars be paid for each share of Northwest stock acquired precluded this transaction from being a distribution "with respect to its stock," the Tax Court made this observation in its opinion:

> "If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock." (Emphasis in original.)

As taxpayers concede, the fundamental basis of nonrecognition of gain or loss under section 355 is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization.[16] Consistent with that concept section 355(a)(1)(D) provides, in effect, that distributions made pursuant to section 355(a)(1)(A) must be made pursuant to a plan which contemplates a distribution to the shareholders of the distributing corporation of a controlling portion of the stock or securities of the controlled corporation.

Congress could well conclude that the prospect that the same people (shareholders of the distributing company) will continue to own the same business would be undermined if a distribution was effectuated by means of transferable stock rights, the exercise of which required substantial cash payments. We do not decide whether the

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[16]See Treasury Regulations on Income Tax (1954 Code) § 1.355-2(c); 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision), § 20.102, page 507.

transferability of stock rights would, without more, run counter to the overall concept of section 355. But when transferability is coupled with a requirement for a cash payment, it could well be that a substantial number of the distributing corporation's shareholders would, under the circumstances of a particular case, choose to sell their stock rights rather than to themselves make the cash payment which exercise of the stock rights would entail.[17]

Considered in this light, it is not at all inconceivable to us that Congress would be willing to treat a distribution as tax-free when made without consideration, but would be unwilling to so treat a distribution of assignable stock rights which requires a cash payment.

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[17] The Tax Court was of the opinion that since more than eighty percent of the shares of Northwest had been finally distributed to Pacific shareholders as of 1963, the control requirement of either (i) or (ii) of section 355(a)(1)(D) had been satisfied. However, we are not here concerned with whether, as events finally unfolded, Pacific shareholders obtained control of Northwest. Section 355 is designed to assure that, unless such retention of control is reasonably certain at the time of initial distribution, non-recognition of gain will not be effectuated. Stated differently, fulfillment of the control requisite is to be adjudged as of the date of the initial distribution rather than by recourse to hindsight in each case after the transaction has been fully consummated.

It is therefore immaterial that, in this case, taxpayers did exercise their stock rights and that, upon completion of the plan in question, more than ninety-five percent of the Northwest stock was owned by the same Pacific shareholders to whom the rights to acquire Northwest stock were distributed. This is particularly true in this case because at the time of the original distribution of fifty-seven percent of the Northwest stock in 1961, it could not be determined whether shareholders of the distributing corporation would receive a controlling amount of the stock in Northwest as required by section 355(a)(1)(D).

It is likewise without controlling significance that section 355 (a)(1)(B), quoted in note 6 above, was also perhaps designed in part to retain the business in the same ownership by disallowing this reorganization procedure of section 355 to be used as a device for distributing the earnings and profits of the distributing corporation or the controlled corporation, or both.

We therefore conclude that, as contended by the Commissioner in his first two arguments advanced on this appeal, Pacific did not distribute Northwest stock to taxpayers "with respect to its stock," as required by section 355(a)(1)(A) and, for this reason, section 355 does not excuse taxpayers from recognition of gain realized by them on the transaction in question.

The conclusion just stated makes it necessary to reverse the Tax Court decision. In addition, an independent reason for reversal is disclosed by the Commissioner's argument that Pacific did not distribute control of Northwest in a single distribution, as assertedly required by section 355(a)(1)(D).[18]

At the outset, we are confronted with the Commissioner's admission that this argument is advanced for the first time in this court. While the Tax Court was not given an opportunity to voice an opinion as to this contention, since it involves a question of law relative to facts which are not in dispute, we may and do, in the exercise of our discretion, consider this additional argument.[19]

As noted above, Pacific distributed stock purchase rights in September, 1961, and in that year distributed only

[18] This is the third of the Commissioner's four principal arguments, as listed earlier in this opinion.

[19] In their brief in this court, taxpayers note that this argument is made for the first time on review by this court. They do not contend, however, that this circumstance precludes consideration of the argument here, and they have fully responded to the argument on the merits. The considerations for determining whether this court should allow issues to be raised which were not brought before the Tax Court are set forth in *MacRae v. Commissioner*, 9 Cir., 294 F.2d 56, 59, in which a new argument, advanced for the first time in this court was considered and found to be meritorious.

fifty-seven percent of the Northwest stock which it held. Not until almost two years later, in June, 1963, did Pacific dispose of the remaining forty-three percent of Northwest stock by making another stock purchase right offering. On the basis of these facts, the Commissioner argues that as of 1961, the tax year here in question, Pacific had failed to offer at least eighty percent of the Northwest stock, thereby violating the divestiture of control requirement of Section 355 (a)(1)(D).[20]

In support of his single distribution theory, and as an indication that section 355, by necessary implication, requires that the date of distribution of a controlling interest in the controlled corporation be a readily identifiable date at the time of the initial distribution, the Commissioner calls attention to the following: (1) both section 355(a)(1)(A) and section 355(a)(1)(D) require that the distributing corporation be in "control" of the controlled corporation "immediately before" the distribution; (2) section 355 (b)(1)(A) requires that "immediately after distribution" both the distributing and the controlled corporation must be engaged in an active business; and (3) section 355(b)(2)(B) requires that the controlled corporation business must have been conducted for a period of five years, ending on the "date of distribution." See note 6 above, for the full text of these subsections.

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[20] As is apparent from a reading of section 355(a)(1)(D), quoted in note 6 above, as part of the distribution, the distributing corporation must distribute (i) all of the stock in the controlled corporation, or (ii) an amount of stock constituting "control" within the meaning of section 368(c), 26 U.S.C. § 368(c) (1964). "Control," as defined in section 368(c), is the ownership of at least eighty percent of the total combined voting stock in a corporation and at least eighty percent of all other classes of stock of a corporation.

In answer, taxpayers in effect contend that section 355 does not require a single "distribution," but only a single "transaction," and that the two transfers of Northwest stock should be viewed as parts of a single transaction because both offerings were "contemplated and required by the plan of reorganization," which was conceived early in 1961. We have examined the exhibits submitted in the Tax Court, however, and find no requirement or general agreement that the remaining stock in Northwest would be distributed in 1963. To the contrary, the plan as explained in the "Proxy Statement" to Pacific shareholders for the 1961 offering of Northwest stock, makes it clear that the remaining shares of Northwest (forty-three percent) would be offered at a "time or times related to its (Pacific's) need for new capital."[21]

Although a "tentative schedule" set forth in Pacific's presentation of its plan does indicate that a second offering of Northwest stock might take place in December, 1962, and a final offering in December, 1963, it is obvious that such a schedule was not binding on Pacific because the only other actual offering of Northwest stock took place in June, 1963. The indefiniteness of the plan to distribute the remaining shares of Northwest is further evidenced by a recital in the Pacific plan for reorganization, to the effect that the number of shares to be offered to Pacific shareholders in any one offering, the number of offerings to be made, and the price at which these shares would be offered would be determined by the board of directors of Pacific "in its sole discretion."

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[21]The agreement entered into between Pacific and Northwest incorporated the "Proxy Statement" referred to above.

In support of their contention that a single distribution is not required under section 355, taxpayers cite several cases interpreting section 351(a), a corporate organization provision which provides in part:

> "No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons soley in exchange for stock or securities in such corporation and *immediately after* the exchange such person or persons are in control . . . of the corporation." (Emphasis supplied.)

In *Halliburton v. Commissioner*, 9 Cir., 78 F.2d 265, summarized by this court in *Commissioner v. Schumacher Wall Board Corporation*, 9 Cir., 93 F.2d 79, 82, we held that although it took twenty-two days and two separate distributions of stock to issue the entire authorized stock of a new corporation, the pre-existing contract which provided for such an arrangement made it necessary to view the entire proceeding as a "single transaction."

Likewise, in *Portland Oil Co. v. Commissioner*, 1 Cir., 109 F.2d 479, the First Circuit noted that the transfers there involved need not be effected simultaneously, "where executed in pursuance of an *antecedent arrangement*." (Emphasis supplied.) 109 F.2d at 488. The court pointed out, however, that such an arrangement need not be legally binding if made pursuant to a pre-existing agreement between the parties beneficially interested.

For this latter proposition, the court relied upon our decision in *Von's Investment Co., Ltd. v. Commissioner*, 9 Cir., 92 F.2d 861, in which we held that two transfers by different persons may constitute a single transaction even though the transfers were separated by a five-week inter-

val. It is critical to note, however, that this court rested its decision upon a further finding to be thereafter made by the Tax Board as to whether both transfers were made in furtherance of, and for the purpose of executing and putting into effect, the plan of reorganization embodied in an earlier contract between the interested parties.

We do not find the factual situations presented by the cases just discussed to be analogous to the circumstances of the case now before this court. In the instant case the contract between Pacific and Northwest gave no definite date upon which the remaining shares of Northwest would be distributed, and as of 1961, the time of the original distribution of Northwest stock, it was impossible to determine whether the final distribution would take place in two, three or even ten years, depending upon Pacific's need for additional capital.

Additional practical problems in the administration of section 355 would be presented if section 355 were held applicable in these circumstances. Since control could only be established after eighty percent of the Northwest stock had been distributed to Pacific shareholders, it would be impossible for the taxpayers or the Commissioner to evaluate the applicability of the particular provisions of section 355, listed above, until the time when, by subsequent distribution, the eighty percent requirement should be met. Until then, which in this case was 1963, but might just as well have been years later, taxpayers had no way of knowing whether, in computing their taxes for 1961, the benefits of section 355 were available. Likewise until then, the Commissioner would be held at bay in determining the accuracy of taxpayers' 1961 tax return.

Such an interpretation would run counter to the purpose of section 355.[22]

Taxpayers further assert that other reorganization provisions have always permitted various steps in consummating plans of reorganization as part of a single transaction. Although certain reorganizations may necessitate various steps before a reorganization may be effected, no such circumstance is presented here. It did not require the nearly two-year period which transpired in the instant case to distribute the percentage of Northwest stock required to fit within the provisions of section 355. The only apparent reason for this delay was Pacific's lack of need for additional capital at the time of the original distribution of Northwest stock.[23]

Under these circumstances, we think that a fair interpretation of section 355 requires that there be a single transaction in which a controlling interest is transferred and that for two or more distributions to be entitled to

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[22] A practical problem is also posed by section 355(b)(1) and (2), which requires that the distributing corporation must have been conducted for a period of five years ending on "the date of the distribution." Since "control," as defined in section 368(c), did not pass out of Pacific's hands until the 1963 distribution of Northwest stock, this could be considered the "date of distribution." Such an interpretation, however, would allow the distributing corporation to circumvent this 355 subsection by extending the date at which final distribution of control would be completed.

[23] In its presentation of the plan in question, Pacific stated that its reasons for selling about fifty-six percent of the Northwest stock, rather than more or less were as follows: (1) to allow the parent corporation, American, to acquire more than fifty percent control of Northwest and thereby relieve Pacific of the responsibility of such control, and (2) the sale of this percentage of Northwest stock would enable Pacific to obtain the cash needed to pay off its advances from American without having excess cash left over which would have to be temporarily invested at a low return.

treatment as a single transaction transferring control of the controlled corporation to the shareholders of the distributing corporation, such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions, apart from other considerations such as Pacific here had in mind in extending the distributions over a period of nearly two years. Applying this test, we hold that the control requirement of section 355 has not been met in this case.

In view of our conclusions reached above regarding the inapplicability of section 355 for each of the three reasons discussed, we need not consider the fourth reason advanced by the Commissioner.

In the Tax Court, taxpayers asserted several alternative arguments for the non-taxability of the distribution in question. The Tax Court did not consider and decide those alternative arguments. Since we are now rejecting the application of section 355 under the circumstances of this case, we remand the case to the Tax Court for consideration of taxpayers' alternative arguments.

Reversed and remanded for further proceedings consistent with this opinion.

Appendix D

UNITED STATES COURT OF APPEALS
For the Ninth Circuit

Commissioner of Internal Revenue, Petitioner, vs. Oscar E. Baan, Respondent.	No. 20,863

JUDGMENT

Upon Petition to Review a Decision of The Tax Court of the United States, ...

....

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States,

....

....

.... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the .... Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed and that this cause be and hereby is remanded to the said Tax Court for further proceedings consistent with the opinion of this Court.

Filed and entered July 7, 1967

Appendix E

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 214—September Term, 1966.

(Argued January 24, 1967 Decided July 26, 1967.)

Docket No. 30572

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

—v.—

IRVING GORDON and MARGARET GORDON,
Respondents.

IRVING GORDON and MARGARET GORDON,
Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before:

MOORE and FRIENDLY, *Circuit Judges;*
BRYAN,* *District Judge.*

*For the Southern District of New York, sitting by designation.

Petition for review of a decision of the Tax Court of the United States, Raum, *Judge*. The Commissioner of Internal Revenue petitions this Court to review a decision of the Tax Court that a distribution of stock to the taxpayers was governed by Section 355 of the Internal Revenue Code of 1954. Taxpayer seeks review of a decision that the sale of stock rights constituted dividend income. Opinion below reported at 45 T. C. 71. Affirmed in part and reversed in part.

Martin T. Goldblum, Washington, D. C. (Mitchell Rogovin, Assistant Attorney General; Lee A. Jackson, Gilbert E. Andrews, on the brief), *for petitioner-respondent.*

Harry R. Horrow, San Francisco, California (Stephen J. Martin, Pillsbury, Madison & Sutro, San Francisco, California, on the brief), *for respondents-petitioners.*

Moore, *Circuit Judge:*

The taxpayers, Irving and Margaret Gordon (husband and wife) in 1961 owned 1,540 shares of Pacific Telephone and Telegraph Company (Pacific) common stock. Their stock certificate represented a fractional part, in theory at least, of all the assets of this company. Although collectively the stockholders owned these assets, the corporate form was not within the control of the individual stockholder but, for all practical purposes, in the control of the company's management. Therefore, when Pacific decided

to have its assets held by two corporations instead of one, the position of the Gordons remained unchanged. They merely needed to have another piece of paper to evidence their same fractional asset ownership. This, in substance, Pacific supplied. However, as a result of the transaction, the Commissioner of Internal Revenue (the Commissioner) has assessed an income tax against the Gordons who properly ask, probably in some wonderment, how this corporate change of asset ownership brought income to them and, if so, where is it?

Before considering the facts, which are not in dispute, the trite statement that an income tax should be a tax on income may serve as a beacon. All too frequently, Commissioners and courts launch into an analysis of tax sections, subsections, paragraphs and subparagraphs which practically exhaust the alphabet and Roman and Arabic numbers. In this intellectual exercise, the taxpayer often is only an incidental (though necessary) figure. Therefore, this review will be based on the principle that the ultimate question to be answered is: did the Gordons receive taxable income within the meaning of the Code because of their ownership of a Pacific stock certificate? It must be presumed that in enacting all the sections of the Code, relating to corporate changes, Congress adhered to the fundamental purpose of taxing income. The Tax Court, 45 T. C. 71, has held that they did not as to 1,536 shares; the Commissioner appeals. As to four (4) stock rights sold, the Tax Court held that income resulted and the Gordons appeal. We affirm the Tax Court as to the Commissioner's appeal and reverse as to the Gordons' (taxpayers') appeal.

The principal question presented by this petition to review the decision of the Tax Court is whether the nonrecognition provisions of Section 355 of the Internal Revenue Code of 1954 can be applied to a spin-off by Pacific of a part of its assets. Pacific is a subsidiary of the American Telephone and Telegraph Company (AT&T) which at all times owned over 80% of Pacific's common stock. Prior to July 1, 1961, Pacific provided the telephone services for California, Oregon, Washington and Idaho.[1] This is a rapidly growing area of the country and for purely business reasons, Pacific decided to divide the corporation. To this end a new corporation, Pacific Northwest Bell Telephone Company (Northwest), was formed to take over the non-California business of Pacific. Pacific's management studied a variety of methods by which to effect the division, one of which was a conventional spin-off which clearly would have qualified under Section 355.[2] This method was rejected partly because

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[1]Pacific also provided telephone service in Nevada through a wholly-owned subsidiary which was not included in the spin-off here considered.

[2]Section 355 of the Internal Revenue Code of 1954 reads as follows:

"Sec. 355. Distribution of Stock and Securities of a Controlled Corporation.

(a) Effect on Distributees.

(1) General Rule.—If—

(A) a corporation (referred to in this section as the 'distributing corporation')—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the

of state law obstacles and, presumably, partly because the AT&T family filed a consolidated tax return which eliminated intercorporate dividends and thus qualification under Section 355 was not of great importance to the corporate management. It is, however, vital to the minority Pacific stockholders and to the taxpayers

distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to ~~all~~ of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the

Gordon, who owned 1,540 shares of Pacific common stock. It is their position that regardless of what the Pacific management intended, the distribution should be given the preferred tax treatment provided by Section 355.

The plan ultimately agreed upon required Pacific to transfer to Northwest all of the non-California assets and liabilities plus $110,000 in cash in return for the issuance of 30,460,000 shares of Northwest common stock and an interest bearing demand note in the amount of $200,000,-000. The result of these arrangements was to give Northwest a capital structure similar to that of Pacific. On June 30, 1961, Pacific ceased all non-California business. This

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principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross Reference.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after

Plan, which had been accepted by the Pacific shareholders in March of 1961, further required Pacific to offer to its shareholders the right to purchase *all* of the Northwest stock held by Pacific on a pro rata basis. It was left to the sole discretion of the Pacific management, however, to determine the number of offerings of Northwest stock to the Pacific shareholders and the price at which the stock would be made available. The Plan, nevertheless, made it clear that these decisions were to be made in response to the capital requirements of Pacific and it was anticipated that all of the Northwest stock would be distributed within three years. On September 20, 1961, Pacific issued

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the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period."

one transferable stock right for each outstanding share of Pacific stock. Six such rights plus a payment of $16 were required to subscribe to one share of Northwest stock, which at this time had a fair market value of $26 per share. This initial distribution involved approximately 57% of the Northwest stock held by Pacific, an amount selected in order to pass control of Northwest to AT&T immediately following the first stage of the distribution. A second and final offering, the terms of which required eight rights plus $16 to obtain one share of Northwest stock, was made on June 12, 1963, of the remaining 43% of the stock.

Pacific adopted this more complex mechanism for distribution to enable it to satisfy simultaneously its very large requirements for additional capital to finance expansion. In each annual period prior to 1961, Pacific had been required to issue common stock or debentures in an average amount of nearly 200 million dollars per year. In the three years following 1961, however, these capital requirements were satisfied through the funds received from its distribution of Northwest stock and no common stock or debentures were issued.

In response to a request by Pacific, the Commissioner issued a ruling letter prior to the first offering which concluded that the sale of the rights would produce ordinary income and that their exercise would constitute a dividend under Section 301. He further stated that Section 355 would not be applicable.

This appeal involves only the tax year of 1961. The taxpayers exercised 1,536 of the 1,540 rights they received

that year. On their income tax return, the taxpayers took the position that this aspect of the transaction was not subject to tax and therefore reported no gain or loss. The other four rights were sold for a total amount of $6.36, which was reported as a capital gain. On July 19, 1963, the Commissioner assessed a deficiency of $895.10 based on these transactions.

I.

It is not disputed that the Pacific-Northwest corporate division fulfilled a valid business purpose. Nor is it disputed that the method selected by Pacific to accomplish this division was dictated by valid business reasons. In fact, it does not appear to be disputed that there was no possibility under this transaction for turning ordinary income into capital gains—the evil which Section 355 was designed to prevent. Rather, the government contends that in a number of technical respects, the requirements of that Section were not met and that, therefore, the distribution of Northwest stock must be treated as a dividend. While the government raises a number of purely technical questions to which we shall shortly turn, the truly decisive question before this Court is how Section 355 shall be construed. The taxpayers argue that Section 355 is the embodiment of a Congressional decision that corporate divisions are desirable as a matter of public policy and should not be impeded by tax considerations. Congress recognized, of course, that corporate divisions are a perfect vehicle for bail-outs of earnings and profits and, therefore, hedged in the use of Section 355 with a number of conditions which must be met. But when the division presents no opportunity for a bail-out, these con-

ditions should not be so construed as to frustrate the basic Congressional purpose. The Commissioner, for his part, argues that Section 355 is merely a tax concession granted by Congress to permit certain narrowly defined transactions. He concludes that, as with all such privileges, the statute is to be narrowly construed.

In evaluating the jurisprudential philosophy of the government, we are not required to limit our search to the instant case in which it serves the Commissioner's purpose to argue for a narrow construction. Initially, we note the long line of cases holding that mere compliance with the reorganization sections does not ensure a tax-free exchange if there is lacking a business purpose or, perhaps, a continuity of interest in the transaction. See, e.g., *Gregory v. Helvering*, 293 U. S. 465 (1935), *Bazley v. Commissioner*, 331 U. S. 737 (1947). While, obviously, the converse of this proposition is not true, these cases properly stand for the proposition that in determining tax results, the courts do not merely look to the literal language of the statute but also view the business transaction as a whole in conjunction with the underlying purpose of the taxing statute. We are not aware of any rule of law that preserves such a salutary tenet of construction for the exclusive benefit of the Commissioner. See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U. S. 179 (1942).[3]

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[3]In sustaining the contention of the taxpayer that a reorganization had occurred, the Court stated:

"Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet, the separate steps were integrated parts of a single scheme.

Furthermore, we note that the Commissioner has not always taken such a constricted view of the reorganization sections. When it serves his purpose, the Commissioner has argued that when a reorganization has in fact occurred, it should be taxed under the reorganization sections of the Code even though the strict requirements of the statute have not been met. See, e.g., *Gallagher v. Commissioner,* 39 T.C. 144 (1962); *Berghash v. Commissioner,* 43 T.C. 743 (1965), *aff'd* 361 F. 2d 257 (2 Cir. 1966).

While we think it beyond dispute that the courts are permitted a certain flexibility in applying the Code, it should be added that cases in which the courts must stray from the literal language of the Code in order to achieve its underlying objectives will not be frequent. Conversely, however, undermining the general purposes of the Code through an overly literal application of each of its technical provisions cannot be justified. Here it is evident that the taxpayers' investment remained in corporate solution (aside from the $6.36) and merely changed its form. The only additional factor was the payment of $16 per share which was in reality tantamount to a contribution to capital and that, of course, is no occasion for the imposition of a tax. Nor was there any opportunity for the taxpayers to use this transaction for a bail-out of earnings and profits. On the other hand, if the Commissioner prevails,

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Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. *Gregory v. Helvering,* 293 U. S. 465; *Helvering v. Bashford,* 302 U. S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan." 315 U. S. at 184-85.

taxpayers' equity investment will be turned into ordinary income.

Wholly aside from these considerations of a general nature, an examination of the specific objections made by the Commissioner reveals that at the maximum, this division strayed from the literal terms of Section 355 in only very minor respects.

A. *"Distributes . . . with respect to its stock."*

From the taxpayers' point of view, they found themselves holding two pieces of paper, a certificate for 1,540 shares of Pacific, and a certificate for 1,540 rights, which when exercised, together represented their ownership in Pacific's assets, including a $16 capital contribution, certainly not an income-producing act. They were neither richer nor poorer. Neither the receipt of the rights certificate and its exercise nor the capital contribution produced any income to them. The Tax Court quite properly observed that

> "If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock." (Emphasis in original.) 45 T. C. 71.

Subsection (a)(1)(A)(i) requires that the stock of Northwest be distributed by Pacific with respect to the Pacific stock. The Commissioner argues that in fact Pacific distributed only stock rights with respect to its stock and that the Northwest stock was exchanged for six

rights, which could have been purchased through the market by anyone and \$16 and, thus, qualification under Section 355 is barred because a distribution of stock rights does not satisfy the statute. We think the result contended for by the Commissioner is precluded by *Palmer v. Commissioner,* 302 U. S. 63 (1937) and *Choate v. Commissioner,* 129 F. 2d 684 (2 Cir. 1942). Normally, the distribution of a stock right has no tax consequences because there is no distribution of corporate property until the right is exercised.[4] A sale or exchange of a stock right prior to exercise results in a tax only because it is an anticipation of gain from an exercise. It follows in this case that it is the actual distribution of the Northwest stock upon the exercise of the rights that is the relevant event and the use of the stock rights as a mere mechanism to accomplish this result should be disregarded. Compare *Kimbell-Diamond Milling Co. v. Commissioner,* 14 T. C. 74 (1950), *aff'd,* 187 F. 2d 718 (5 Cir. 1951); *Heller v. Commissioner,* 2 T. C. 371 (1943), *aff'd,* 147 F. 2d 376 (9 Cir. 1945).

Secondly, the Commissioner argues that the phrase "distribution . . . with respect to its stock" is a term of art that excludes the use of a cash consideration such as the \$16 required here. He cites no authority for this proposition and we are aware of none. It is perfectly obvious that the Code does not contemplate the receipt of cash by a corporation in connection with a distribution with respect to its stock in the sense that some specific section of the Code spells out the tax result. See Sections 311(a)

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[4]Possible exceptions such as Section 305(b) have no application to the instant transaction.

and 312(d). But it scarcely follows that the Code prohibits the receipt of cash or that if the instant transaction is classified as falling within Section 355, the tax consequences cannot be determined. The only additional factor present is the payment of the $16 and that can be treated very simply as a contribution to capital by a shareholder. However, this question is not before us.[5]

The ultimate question before us is whether, when a reorganization is coupled with another transaction, these two transactions can, or should, be re-separated for federal income tax purposes. When it suits the Commissioner's convenience, he has so argued. See, *e.g.*, Rev. Rul. 61-156, 1961-2 C. B. 62; Regulations 1.301-1(e) and 1.331-1(c). And if the Code is to conform as closely as possible to economic reality, such a division should be performed when necessary. Of course, if the coupling itself is promotive of the evils which the taxing statute was designed to prevent, a separation for tax purposes should not be made for then the taxpayers would have obtained the best of all possible results to the prejudice of the fisc. Here the Tax Court concluded that no conceivable purpose would be served by denying tax-relief when the taxpayer paid out cash while such relief was granted absent this expense. The Commissioner answers the Tax Court by arguing that the use of transferable stock rights plus the $16 requirement "predictably will diminish the continuity of ownership." Thus the Commissioner invokes the judicial gloss on the reorganization sections that, with some exceptions, continuity of interest

[5] Although Pacific appears to have treated the cash obtained from the minority stockholders as gain from the sale of property, that is no bar to these taxpayers.

must be maintained. The short answer to this argument is that it was. The doctrine of continuity of interest has never to our knowledge been used to void a reorganization on the ground that some shareholders might have sold their stock. Indeed, such a rule would void each and every attempted reorganization for with rare exceptions, stock can always be sold as Congress expressly permitted in Section 355(a)(1)(B). Rather, this limitation is applied to the actual result of a transaction: was a continuity of interest in fact maintained? Here over 95% of the shareholders in Pacific before 1961 exercised their rights and became shareholders in Northwest. Further, AT&T itself owned over 80% of the Pacific stock and after the division owned over 80% of both Pacific and Northwest. The doctrine of continuity of interest asks no more.[6]

B. *"Transaction in which gain or loss was recognized."*

The Commissioner further takes the position that qualification under Section 355 is barred by the requirement of Section 355(b)(2)(C) that the trade or business which is being actively conducted by either the controlled or the distributing corporation was not acquired in a transaction in which gain or loss was recognized. Taxpayers argue and the Tax Court agreed that because any

[6]In *Commissioner v. Baan,* .... F. 2d .... (9 Cir. 1967), which arose out of the same corporate division and was decided by the Tax Court with the instant case, it was held that the requirements of Section 355 had not been met. One of the principal grounds of that decision was that while the mere use of stock rights may not preclude a tax-free division, the added condition of a $16 payment barred the application of Section 355 because of the danger that a continuity of interest would not be maintained.

gain or loss on the intercorporate transaction was eliminated on the consolidated tax return of these affiliated corporations, this condition of the Section was satisfied. Analysis of the purposes underlying subsections (b)(2)(C) and (D) prohibits acceptance of this conclusion because the happenstance of affiliation does not remove the danger of purchasing a corporation for the purpose of distributing its stock as a dividend while avoiding the tax on dividends. However, this same analysis of the statute indicates clearly, we think, that 355(b)(2)(C) has no application to this case. The theory underlying 355(b), the active business requirement, is the prevention of the temporary investment of liquid assets in a new business in preparation for a 355(a) division. The primary danger envisioned by the draftsmen of this Section was the creation of the new business and the safeguard was the five-year provision. The reasoning is that if the new business must be operated for at least five years, there will be little incentive to use this device for tax avoidance purposes. The second danger was that instead of creating a new business, the corporation would purchase one which had been in existence for over five years and then distribute its stock in place of a dividend. To safeguard against this possibility, subsections (b)(2)(C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized. In our case no new business, no new assets and no new corporation was acquired at all. No liquid assets were temporarily invested nor, in fact, was there any temporary investment. Consequently, the application of these sections to the instant transaction

would serve no purpose at all. We think that the draftsmen of Section 355 intended these subsections to apply only to the bringing of new assets within the combined corporate shells of the distributing and the controlled corporations. Therefore, it is irrelevant in this case whether gain was recognized on the intercorporate transfer.

C. *Single Distribution.*

Finally, the Commissioner argues that there is an implied requirement in Section 355 that the distribution of stock take place in a single offering and since Pacific utilized two offerings separated by almost two years, the statutory requirement has not been met. It is conceded that there is no direct authority for this proposition but the Commissioner argues that such a result is demanded by the scheme of Section 355. In particular, he refers to subsection (a)(1)(D) which reads as follows:

> (D) as part of the distribution, the distributing corporation distributes—
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> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
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> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

* * * * * * *

On its face, this subsection is simply the embodiment of the Congressional decision that only complete, and not partial, divisions were to receive tax-free status and its purpose seems limited to establishing the amount of stock which must be distributed for qualification under Section 355. Both subdivisions require that the distributing corporation distribute an amount of stock in the controlled corporation constituting control. Subdivision (D)(i) imposes the additional requirement that the distributing corporation distribute all of the stock held "immediately before" the distribution to its shareholders, even if that amount is less than all of the outstanding stock. The quoted language in no way requires a single distribution but is merely the means used to permit distribution of less than all of the outstanding stock in the controlled corporation. Alternatively, the corporation may proceed under (D)(ii) which permits retention of stock to a limited degree. Permitting retention at all is a departure from prior law and from the Congressional policy of complete division at the corporate level. To prevent abuse, Congress added to this subdivision a requirement that the taxpayer affirmatively demonstate the absence of tax avoidance objectives instead of requiring the Commissioner to move under subsection (a)(1)(B). Here again, the fact that Congress permitted limited retention after the completion of the distribution cannot be said to imply that the distribution must have but a single phase. Thus there is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution. These matters are entirely governed by the more flexible "device" clause

of Section 355(a)(1)(B) which is fully adequate for this purpose and which clearly is no bar to the qualification of this corporate division. As there is no dispute that in both the original plan and in the fact a complete division occurred, applying the statute in this, the most obvious, manner and giving its words their everyday import compel the conclusion that subsection (a)(1)(D) was satisfied.

The Commissioner, however, contends that the requirements of subsection (a)(1)(D) "undoubtedly" were designed to prevent periodic distributions of stock in the controlled corporation as a substitute for dividends. The only authority for this proposition is Professor Bittker who, in discussing the requirement of explaining retention to the Secretary, "presumes" this purpose. But Professor Bittker was not addressing himself to the question of a single distribution and the Commissioner omits to cite his further observation in the same paragraph that such an abuse would clearly be prohibited by subsection 355(a)(1)(B), the "device" clause, and thus if that is the purpose of the subsection, it is redundant. He further notes that there does not appear to be any necessity for the provision in any event. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 479 (2 Ed. 1966). Another commentator states that the requirement of subsection (a)(1)(D) "is designed to differentiate between genuine separations and incidental distributions of a controlled corporation's stock which take the place of current cash dividends." Surrey & Warren, Federal Income Taxation 1640 (1962). The Commissioner does not suggest that the instant transaction was not a genuine

division nor could it conceivably be considered a substitute for a current dividend.

Whether a corporation has retained stock or distributed it is simply a question of the point in time that the manipulation is examined. The Commissioner argues that this point is immediately after the first transaction and that subsection (a)(1)(D)(ii) prohibits "retaining" over 20% of the stock after this point. The taxpayers argue that the time is after the culmination of the plan of distribution and that subsection (a)(1)(D)(ii) only prohibits an indefinite retention.[7] On its face Section 355 gives little guidance but we do know that neither of the purposes suggested for subsection (a)(1)(D) will be defeated by permitting more than one distribution and that the construction of that provision for which the Commissioner argues does not fit easily within its language. But an adequate restriction is already provided by subsection (a)(1)(B).

Further, the incongruity of the result urged by the Commissioner when viewed against other provisions of the Code creates considerable doubt that Congress would intentionally require a single distribution. In 1961 Pacific was the eighth largest non-financial company in the United States and had over 38,000 shareholders. The reorganization resulted in a distribution of over 30 million shares of Northwest stock and raised for Pacific nearly one-half billion dollars. A requirement that such a trans-

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[7] While the Plan adopted by Pacific theoretically might have permitted this, the surrounding facts make it certain, as found below, that long-term retention was never intended and, of course, was not the fact. In the future, it would be preferable that such plans set out the timetable of distribution more precisely, as undoubtedly the Commissioner will require.

action occur on a single day would be staggering. As far as this Court is aware, none of the other reorganization sections impose such a requirement, aside from the highly limited scope of *Bausch & Lomb Optical Co. v. Commissioner,* 276 F. 2d 75 (2 Cir. 1959), which is not relevant here. Regulations 1.368-2(c); Rev. Rul. 58-93, 1958-1 C. B. 188. See also Sections 332(b) and 337(a).

As it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution, such a requirement cannot be read into the Code, at least without a substantial reason. A fair reading of the Commissioner's brief indicates that he fears two problems from the result reached below. First, he suggests the danger of periodic distributions as a substitute for dividends and the tax avoidance that this would permit. But as we have noted, it is not clear that there are tax avoidance possibilities in such a scheme so long as the active business requirements are met; if they could be shown to exist, the "device" clause would prohibit any bail-out.

Second, the Commissioner points to a number of administrative difficulties inherent in permitting more than a single distribution such as leaving open the tax result for several years, the problem of defining the "date of distribution," and the difficulty in ascertaining whether there was control "immediately before" the distribution.[8]

[8]The fact that the two transactions which we hold constituted a single distribution occurred in different tax years is of no significance. Had the transactions occurred in January and December of 1961, we would be faced with the same questions as this case presents. The Commissioner makes no point of the fact that two tax years are involved, nor could he. See *Pridemark, Inc. v. Commissioner,* 345 F. 2d 34 (4 Cir. 1965).

But the facts of this case can hardly be said to create the insurmountable administrative difficulties which the Commissioner has paraded before us in his brief. Here only two transactions occurred covering a maximum of three tax years. In fact, the deficiency notice in this case was not sent until July of 1963, two months after the second distribution was authorized. The Commissioner attacks the Tax Court by asserting that its opinion would permit ten distributions of 10% of the Northwest stock, an assertion most doubtful in itself for it overlooks the impact of subsection (a)(1)(B). But that is not our case and it can scarcely be contested that the Code imposes a tax on facts, not expectations. Perhaps the enormity of the administrative difficulties may be measured in part by the failure of the Commissioner to raise the single distribution point in the Tax Court.[9]

Conceding that some administrative problems will arise from our decision, they hardly provide a justification for denying tax-free reorganization status to a legitimate spin-off that entails none of the tax avoidance features that Section 355 was designed to prevent. In any event, we think it is the task of the Commissioner to resolve these difficulties, not the courts'. Nothing in our opinion prevents the Commissioner from drafting reasonable Regulations limiting the time period within which the entire dis-

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[9]In *Commissioner v. Baan, supra,* the Ninth Circuit alternatively held that while a single distribution was not required by subsection (a)(1)(D), because of the difficulties in administration, "such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions." While this approach effectively compromises the harshness of the Commissioner's argument, the statute contains no such requirement.

tribution must be made, or the number of transactions which may be involved, or specifying what advance notice must be provided the Service, or defining the statutory language quoted above. But we are not prepared to apply retrospectively restrictions directed at evils which this case does not present.

The decision of the Tax Court on the Commissioner's petition is affirmed.

II.

Four of the stock rights issued by Pacific were sold by taxpayers for a total amount of $6.36. The Tax Court determined that aside from the effect of Section 355, this distribution by Pacific would be taxable as a dividend. The Court further held that Section 355 could have no application until there had actually been a distribution of stock and, thus, where the rights were disposed of prior to exercise, Section 355 had no application. Such an asymmetrical approach to Section 355 is untenable.

It is well settled that the exercise of a stock right may result in dividend income if the fair market value of the acquired stock exceeds the option price. *Palmer v. Commissioner*, 302 U. S. 63 (1937); *Choate v. Commissioner*, 129 F. 2d 684 (2 Cir. 1942). And since the sale of a right may be an anticipatory realization of dividend income, gain on the sale is similarly taxed at ordinary income rates. *Helvering v. Horst*, 311 U. S. 112 (1940), *Gibson v. Commissioner*, 133 F. 2d 308 (2 Cir. 1943). However, in a transaction to which Section 355 applies, the distribution of stock by a corporation does not result in a dividend even though the distribution was accomplished by the use

of stock rights and the option price was less than the fair market value of the acquired stock. The assumption of such cases as *Palmer* and *Gibson* is that a distribution of corporate earnings results from the existence of a "spread." Section 355, on the other hand, is a statutory device for determining that a distribution of capital, rather than of earnings, has occurred and therefore the assumption of those cases is inapplicable. The reasoning of *Gibson,* however, that the sale of a stock right should be taxed the same as an exercise is controlling. Similar reasoning exists in Code Section 1234(a). And see *Rank v. United States,* 345 F. 2d 337 (5 Cir. 1965). Since the gain on an exercise of these rights, although deferred until the sale of the stock, would be capital, we hold that the sale of the rights similarly gave rise to capital gains. The error of the Tax Court was in forgetting that it is not the individual shares of stock received by these taxpayers that qualify under Section 355 but the entire distribution by Pacific.

The decision of the Tax Court on the taxpayers' petition is reversed.

FRIENDLY, *Circuit Judge* (dissenting):

If in 1962 a revenue agent had reviewed the Gordons' 1961 return which, as stipulated, "did not include as income any amount with respect to the sale of rights to purchase Northwest stock or with respect to the exercise of rights to purchase Northwest stock or with respect to the receipt of such stock," he would have been justified in thinking his task was an easy one, at least so far as con-

cerns the point here decided in favor of the taxpayers. Tender of six such rights plus $16 permitted the purchase of a share of Northwest stock at well below market price.[1] Despite the majority's belief that stockholders realize no income simply because of the receipt of "another piece of paper to evidence their same fractional ownership," *Palmer v. C. I. R.*, 302 U. S. 63 (1937), as interpreted by this court in *Choate v. C. I. R.*, 129 F. 2d 684 (2 Cir. 1943), taught that the sale of exercise of the Pacific rights was dividend income unless some section of the 1954 Internal Revenue Code dictated otherwise. Examining §355, the section held by my brothers to afford a tax shelter, the agent would have encountered subdivision (a)(1)(D), which requires that:

> "as part of the distribution, the distributing corporation distributes—
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> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."

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[1]During the offering period the price of the Northwest shares ranged from $28.25 to $25.25. In determining the value of the rights and consequent dividend income the Commissioner used $26, the average price on October 5, 1961, the day the Gordons exercised their warrants. Taxpayers make no claim that the value of the rights on the day of receipt was less than the amount thus determined.

He would readily have ascertained that Pacific had not met the test of clause (i) since, far from having distributed all the Northwest stock "held by it immediately before the distribution," it retained 13,013,969, approximately 43% of the total of 30,460,000 shares. By the same token Pacific had not complied with clause (ii); the 57% of the stock distributed was nowhere near the 80% "constituting control within the meaning of section 368(c)." If Mr. Gordon had displayed Pacific's letter of February 27, 1961, requesting stockholder assent to the plan and advising "It is expected that within about three years after acquiring the stock of the New Company [Northwest], the Company [Pacific] by one or more offerings will offer for sale the balance of such stock, following the procedure described in the preceding paragraph," the agent could have replied that §355 is concerned with acts rather than expectations. He might also have repeated Mr. Justice Stone's oft-quoted statement, as true today as when written: "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt." *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363 (1931). The agent would therefore have been obligated to recommend the determination of a deficiency, so far at least as §355 was the basis asserting for the taxpayers' return, and this without even having to consider the Commissioner's basic claim, recently sustained by the Ninth Circuit, *C. I. R. v.*

Baan, ——— F. 2d ——— (1967), that a distribution of rights to purchase the stock of a controlled subsidiary at less than its fair value is not within §355(a)(1)(A).

If a court would have sustained the agent in litigation during 1962, as it seemingly would have had to do, I fail to perceive how Pacific's action in ridding itself of the remaining Northwest shares in 1963 can justify a different result. The 1961 taxes of the Gordons and other minority stockholders depend on what Pacific did in 1961, not on what it chose to do in 1963. *Burnet v. Sanford & Brooks Co., supra; see also Healy v. C. I. R.*, 345 U. S. 278, 281 (1953). When Congress has meant the events of one year to affect the tax for another, it has said so in language all can understand. See, e.g., §§172(b), 381, 382, 1301, 1302, 1303. Although the plan adopted by Pacific in 1961 committed it to offer its shareholders "the right to purchase all of the shares of capital stock of the New Company," the plan also provided, subject to an exception not here material, that "the number of shares to be offered to the shareholders of the Pacific Company in any one offering, the number of offerings to be made, and the price at which said shares shall be offered to the shareholders of the Pacific Company shall be determined by the Board of Directors of the Pacific Company in its sole discretion." The qualification was so broad as to deprive the commitment of legal significance, and while in fact the second distribution occurred within 21 months, it is not difficult to think of circumstances, such as adverse regulatory action or restrictions on the procurement of telephone plant due to national emergency, that might have postponed Pacific's need for funds and consequent further

distribution of Northwest stock for many years. Moreover, if the 1961 distribution of some 57% of the stock can be metamorphosed into a distribution of 100% by what occurred two years later, I assume my brothers would also give the 1963 distribution of 43%, which clearly would not qualify on its own since Northwest was not then a "controlled corporation" within §355(a)(1)(A), see §368(c), the color now attributed to its predecessor. Furthermore, under my brothers' view that a corporation satisfies §355(a)(1)(D) if it ultimately rids itself of all the stock of the controlled corporation, the shelter of §355 would extend to a 1961 Pacific stockholder who sold his stock before 1963 and to a 1963 stockholder who had not owned Pacific stock in 1961. How this jibes with the recognized purpose of §355 to give tax-free treatment where there is "a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution," Regulations §1.355-2(c), passes my understanding.

The inspiration for the magic whereby two distributions of 57% and 43% in different years become one of 100% is my brothers' belief that at the end of the process the position of most Pacific stockholders with respect to Northwest shares they had acquired had changed only in their having paid $16 per share to retain what they had owned all along, a feeling—which I share—that the instant transaction was motivated by business considerations and not by a desire for tax avoidance, and an apparent view that §355(a)(1)(D) was an unnecessary

or at least a redundant requirement. Yet the stockholders' investment status would also have been unchanged and the Company's motive equally pure if Pacific had never made the second distribution or if Northwest had been only 79% owned from the outset, and, despite the majority's apparent distaste for the view that distribution of rights to purchase corporate property below market value normally constitutes a dividend, I cannot imagine any court would consider that in such event rights offerings like those here made by Pacific were protected by §355.

Congress has simply not seen fit to exempt all distributions where stockholders' investments remain unchanged from a practical standpoint and no tax avoidance motive is manifest; instead it has chosen to lay down extremely specific conditions which a corporation must follow at its peril if it desires to achieve nonrecognition for its stockholders. Complicated tax statutes particularly invite application of Mr. Justice Holmes' precept, "Men must turn square corners when they deal with the Government," *Rock Island, Ark. & La. R.R. v. United States,* 254 U. S. 141, 143 (1920). In §355(a)(1)(D) Congress elected to convert a vague guideline contained in the Regulations under the 1939 Code that "Ordinarily, the business reasons (as distinguished from any desire to make a distribution of earnings and profits to the shareholders) which support the reorganization and the distribution of the stock will require the distribution of all of the stock received by the transferor corporation in the reorganization," Regs. §39.112(b)(11)-2(c), into a specific statutory requirement: Distribute all at once with no questions

asked, or, if you prefer, distribute not less than 80% of the stock of the controlled corporation and satisfy the Commissioner that any retention was not for a forbidden purpose. When Pacific chose not to comply for what it considered valid business reasons, its stockholders must take the consequences.

The Supreme Court has pertinently instructed us to approach revenue acts with the attitude that "the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Old Colony R.R. v. C. I. R.*, 284 U. S. 552, 560 (1932), citing *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370 (1925). It has also told us that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses," *Crane v. C. I. R.*, 331 U. S. 1, 6 (1947); *Hanover Bank v. C. I. R.*, 369 U. S. 672, 687 (1962). A requirement that a corporation distribute all of a controlled corporation's stock held by it "immediately before the distribution," when read against the basic concept of annual tax accounting, can only mean to distribute all at one time[2]—not to distribute 53% and plan to distribute the rest in a later year or years when and as that suited.[3] With all respect, my brothers seem to be emulat-

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[2]It is setting up a straw man to suggest that this means that the mechanics of a large distribution must be fulfilled "in a single day."

[3]There is the further point, noted in Judge Hamley's able opinion in *Baan, supra*, ... F. 2d ......, ... n. 22, that the concept of *seriatim* distributions might often be inconsistent with the requirement of §355(b)(1)(A) and (2)(B) that the distributing and controlled corporations shall have actively conducted a trade or business "throughout the 5-year period ending on the date of such distribution."

ing Humpty Dumpty when they say that the words of the statute in "their everyday import" authorize such a course,[4] and that the only basis for believing the words mean what they say is the view of a distinguished professor, now endorsed by another court of appeals, who, while thinking that Congress could have been more liberal without seriously affecting the revenue, recognized that "Whatever the validity of the reasons for its existence, §355(a)(1)(D) must of course be complied with." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders §11.07 at 479 (1966). And we do not satisfactorily answer the Commissioner's claim of administrative difficulties by chiding him for failure to have promulgated regulations that would partially seal up the breach in the statute we are attempting to create today. Unless the words used by Congress lead to absurd results, are inconsistent with its apparent purpose, or are filled by history with a meaning different from the ordinary one, none of which can be successfully asserted here, a court's job is to apply what Congress has said.

Since I am in full accord with the Ninth Circuit that Pacific's decision to bypass the requirement of §355(a)(1)(D) prevents §355 from immunizing the income realized on the exercise of the rights,[5] I find it unnecessary to decide

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[4]This comment applies also to such statements as that "The quoted language in no way requires a single distribution," that "there is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution," and that "it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution."

[5]Taxpayers' arguments based on decisions under predecessors of §351(a) are answered in the opinion in *Baan, supra,* .... F. 2d at ....

whether that court or the instant majority is right as to the transaction's meeting the basic test, §355(a)(1)(A), of being a distribution solely of stock or securities of a controlled corporation with respect to stock of the distributing corporation. Certainly the words have an uneasy fit to the transaction here in question. What Pacific distributed "with respect to its stock" was not "solely stock or securities" of a controlled corporation but rights to purchase such stock below market price, and the stock of the controlled corporation was distributed "with respect to" the rights rather than the Pacific stock. But even if the distribution of Northwest stock qualified under §355, I could not agree to reversal of the Tax Court's decision that the proceeds of the sale of rights to purchase Northwest stock constituted ordinary income. *Palmer v. C. I. R., supra,* along with *Choate v. C. I. R.,* 129 F. 2d 684 (2 Cir. 1943), and *Gibson v. C. I. R.,* 133 F. 2d 308 (2 Cir. 1943), instruct us that the value of the rights on receipt would be taxable as ordinary income upon their exercise or sale but for some exemptive provision in the Code. Vaulting the language barriers that seem to prevent the issuance of Northwest stock on the exercise of rights from coming within §355, would not help Pacific's stockholders as to rights they sold. As Judge Raum correctly said, the argument "fails to take into account the nature of Section 355, which is a nonrecognition provision, and can be utilized only by those shareholders who come within its terms"—namely, on the majority's view, shareholders who received a distribution of Northwest stock "in respect of" their Pacific stock. The majority's references to §1234 and to *Rank v. United States,* 345 F. 2d 337 (5 Cir. 1965), are inappo-

site; what is here sought to be taxed is the initial value of the rights, not a gain on their sale. Taxpayers argue that the Tax Court's holding creates an unjustifiable distinction between a stockholder who sells rights to purchase stock of a controlled corporation and one who sells the stock of the latter on a when-issued basis and exercises rights to cover the sale. But "the Commissioner is justified in determining the tax effects of transactions on the basis in which taxpayers have molded them," *Television Industries, Inc. v. C. I. R.*, 284 F. 2d 322, 325 (2 Cir. 1960). Moreover, the actual answer may well be that, for reasons heretofore noted, neither the real nor the hypothetical taxpayer is entitled to the benefit of §355.

On the Commissioner's appeal I would reverse the decision as to §355 and remand for consideration of the other grounds advanced by the taxpayers and not dealt with by the Tax Court; on the taxpayers' appeal I would affirm.